✓PRE-RAM

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

(1) No. 1001-1002

PRESIDENT AND DIRECTORS OF THE MANHATTAN COMPANY,

Petitioner,

v.

CHARLES H. KELBY, CLIFFORD S. KELSEY, Trustees of the Debtor, PRUDENCE-BONDS CORPORATION (NEW CORPORATION), GEORGE E. EDDY, and HILDA S. REESE.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

JOHN LORD O'BRIAN,
J. M. RICHARDSON LYETH,
MARK W. MACLAY,
CHARLES A. HORSKY,
Counsel for Petitioner.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. ....

President and Directors of the Manhattan Company,

Petitioner,

v.

Charles H. Kelby, Clifford S. Kelsey, Trustees of the Debtor, Prudence-Bonds Corporation (New Corporation), George E. Eddy, and Hilda S. Reese.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

President and Directors of The Manhattan Company prays that writs of certiorari issue to review two orders of the United States Circuit Court of Appeals for the Second Circuit entered on February 16, 1945 (R. 657),* affirming in part and modifying in part two decrees entered on March 28, 1944, by the District Court for the Eastern District of New York (R. 11).

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* Unless otherwise indicated references are to the Fifth Series record.

Opinions Below

The opinion of Judge Inch in the District Court for the Eastern District of New York (R. 617-621) is not officially reported. The opinion and supplemental opinion in the Circuit Court of Appeals (R. 632-655) are not yet reported.

Jurisdiction

The orders of the Circuit Court of Appeals, review of which is sought, were entered on February 16, 1945 (R. 657). The jurisdiction of this Court is conferred by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented

1. Whether the decision of the Court below is in conflict with the applicable state law in holding that a technical breach of trust, with no elements of fraud, self-dealing, self-enrichment, or the like warrants a surcharge against the Trustee even though no loss to the trust fund or beneficiaries resulted from the breach.

2. Whether the decision of the Court below is in conflict with the applicable state law in holding that assignees of bonds, who were not holders thereof at the time of the breach of trust, may maintain a representative action against the Trustee for a surcharge.

3. Whether the decision of the Court below is in conflict with decisions of this Court in failing to direct appropriate litigation in the state courts to obtain a conclusive determination as to the applicable state law.

Statement

Prudence-Bonds Corporation (hereinafter referred to as the Debtor) filed its petition for reorganization under Section 77B of the Bankruptcy Act, and in 1938 a general plan of reorganization was approved, together with plans of reorganization for various bond issues, including Prudence-Bonds, Fifth Series and Ninth Series of which petitioner (hereinafter referred to as the Trustee) was Trustee. Pursuant to court order in the reorganization proceedings (R. 22), the Trustee filed its accounts, as Trustee under the Fifth and Ninth Series, and prayed for a judicial settlement and approval. Objections having been filed by Prudence-Bonds Corporation (New Corporation), the Reorganization Trustees, and certain individual bondholders (R. 83-125), hearings were had before a Special Master, who recommended surcharges against the Trustee in each Series (R. 519-575). The facts adduced at those hearings, which are material to the present petition are as follows: *

From 1920 to 1931 the Debtor issued eighteen series of its Prudence-Bonds which were sold to the public, each

* The trust agreements in the two series are substantially identical and the questions presented are the same. For simplicity we state only the facts relating to the Fifth Series with references to the record in that proceeding.

secured by a group of mortgages deposited with a bank under a trust agreement.*

The fundamental scheme of the trust agreement was that (1) the face amount of the collateral in the trust fund should equal, but need not exceed, the face amount of Prudence-Bonds outstanding, (2) the Prudence-Bonds maturing serially every six months should have collateral of an equal face amount maturing six months before or three months after each maturity of Prudence-Bonds, and (3) the pledged collateral and the proceeds of its collection were to be used as a revolving fund to pay the serial maturities of the Debtor's bonds, which were substantially matched against the serial maturities of the collateral. In order to secure its effective operation as such a revolving fund the trust agreement expressly permitted the Debtor to collect and retain interest and principal upon the collateral (R. 316) for the purpose of enabling the Debtor to use such proceeds to pay off its bonds. Two alternative methods of securing that result were provided: (1) The Debtor could deposit monthly with the Trustee cash collections of principal upon the collateral (R. 332), pay off serially maturing bonds with its own money, turn them in to the Trustee for cancellation and reimburse itself by withdrawing cash to the extent of the excess of the face amount of collateral over the face amount of Prudence-Bonds outstanding (R. 317-318); or (2) The Debtor could retain the cash collections, use them to pay an equivalent amount of bonds maturing within six months, and surrender the bonds to the Trustee in lieu of the cash collected (R. 332).

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* The bonds were also guaranteed by the Prudence Company, Inc., but the guarantee is not relevant to the issues here involved. The actual procedure by which the mortgages became collateral for the bonds is stated at R 540-1.

The Debtor largely made use of the first alternative. At various times cash and mortgages were released by the Trustee to the Debtor as excess collateral when the face principal amount of the collateral exceeded the face principal amount of outstanding bonds of the various maturities (R. 556-560). At the times of many of such releases one or more mortgages in the collateral were in default as to semi-annual installment or monthly deposit payments of principal. The Trustee, however, believed in good faith (R. 572), that excess collateral was to be computed without regard to minor defaults of this character and continued to release to the Debtor excess cash and mortgages (R. 555-568). Until June 30, 1931, the defaulted installments of principal on mortgages in the collateral were all cured either by payment or by withdrawal and substitution by the Debtor of cash or non-defaulted mortgages for defaulted mortgages (R. 568). The Special Master dismissed all objections to the releases of cash, aggregating $2,140,351.89 and of mortgages, aggregating $1,004,000, prior to that date (R. 572-573)—which is referred to as the last "clear day"—because no damage to the trust fund resulted therefrom (R. 530). No exception was filed to that ruling.

After June 30, 1931, one mortgage became in default in a principal installment of $510, and this default was never cured (Obj. Exh. 5-13, Sch. 2, p. 14). On October 25, 1931, another mortgage became in default in a principal installment of $2,500 and this default was never cured (*ibid.*). From June 30th to November 30th, when the total defaults in principal installments which were never cured aggregated $3,010, the Trustee released to the Debtor $846,840 of cash as excess collateral (R.

559-560). In total, the Trustee was surcharged with $1,065,565—$949,965 in cash releases and $115,600 as the face amount of one mortgage—released to the Debtor after June 30, 1931 (R. 572-573).

All of the releases of cash to the Debtor for which the Trustee was surcharged were in reimbursement for bonds paid off and delivered by the Debtor to the Trustee for cancellation, or in exchange for such bonds. All of the cash received into the trust fund after June 30, 1931, consisted of collections of principal on the mortgage collateral. The releases of excess collateral were made possible because, during the same period, the Debtor paid off and the Trustee cancelled, serially maturing bonds in an amount substantially in excess of the amount of cash released (Acct. Exh. 5-5). After June 30, 1931, $949,965 cash was released by the Trustee and $1,018,300 face amount of serially maturing bonds were paid and cancelled (R. 64-68, 78-80).

Despite these facts, the District Court approved the report of the Special Master, and ordered the Trustee to pay the sum of $1,066,257.38, with costs (R. 15), with leave to apply at the foot of the decree in the event that any surplus remains after full payment of the publicly-held Fifth Series bonds (R. 17). The District Court based its ruling upon the ground that the withdrawals permitted by the Trustee were improper, though in good faith (R. 618), and that, without regard to any other consideration, the amounts must be restored (R. 620-621).

The Court below, concurring in the judgment of the District Court, held that (1) the trust agreement did not permit the withdrawals of the excess collateral while any default, no matter how trivial, existed in any principal

payment (R. 633-642); (2) New York decisions did not restrict the right of suit to those bondholders who held their bonds at the time the alleged wrong was committed by the Trustee (R. 643-645); (3) New York decisions did not require a showing that damage to the trust fund had resulted from the alleged breach of trust (R. 645-647). With certain modifications of the decree of the District Court not now materal, including the imposition of interest upon the amount of the surcharge from 1931, the decree was affirmed (R. 655).

Specification of Errors To Be Urged

The Circuit Court of Appeals erred:

1. In disregarding and failing to apply the law of New York that a trustee, not guilty of fraud, self-dealing, or self-enrichment, will not be surcharged unless it appears that the loss or damage to the trust fund or beneficiaries resulted from the breach of trust.

2. In disregarding and failing to apply the law of New York that, except in the case where the Trustee has itself received a part of the trust assets, a cause of action against the Trustee for breach of trust may be maintained only by the individual holders of the bonds who held them at the time that the breach of trust occurred.

3. In failing to direct appropriate action in the state courts by which the disputed questions of state law could be finally and authoritatively determined.

4. In affirming the order of the District Court.

Reasons for Granting the Writs

By this petition, a review is not sought of the proper interpretation of the trust agreement, although we believe the decision below was erroneous. No question of fact is presented or sought to be reviewd.

I

The decision below surcharging the Trustee even though the breach of trust was not the cause of a loss to the trust fund is a decision upon an important question of New York law in probable conflict with the controlling New York decisions.

As the statement, *supra,* indicates, the Court below has ruled that the Trustee is surcharged despite the absence of any causal relationship between the acts of the Trustee and the loss to the trust fund.

It would be difficult to imagine a case in which the absence of proximate cause is so apparent. The Special Master held that amounts released before June 30, 1931—the last clear day—resulted in "no ascertainable diminution of the trust fund" (R. 530). This was because the releases had been accompanied by corresponding reductions in the amount of outstanding bonds. After the last clear day, however, the Special Master surcharged the Trustee for the entire amount of the cash released by it with no credit for the bonds paid off and for the resulting diminution of liabilities of the trust fund.

During the period from June 30 to November 30, 1931, the Trustee released to the Debtor $846,840 (R. 64, 65) and bonds were paid off and cancelled in the amount of $924,700 (R. 78, 79). During that same period the de-

faults in payments on mortgages which were never cured totaled only $3,010 (Obj. Exh. 5-13, Sch. 2, pp. 12, 14). The total cash releases after June 30 (including those after November 30), for which the Trustee was surcharged were $949,965 (R. 64-68). During the same period $1,018,300 of bonds were paid off and cancelled and the liabilities of the trust fund were reduced in that amount (R. 78-80). The releases after June 30 resulted in "no ascertainable diminution of the trust fund" for the same reason applicable to releases prior to that date. Thus, the amount of the surcharge did not depend on damage to the trust fund nor is it derived from any legal concept of damages. It depended solely on the fortuitous dates on which defaults occurred which were not later cured. The real cause of the damage to the trust fund is what the Court below called the "Great Depression" (R. 648).

There are, of course, certain types of wrongful acts for which a trustee is held to absolute liability, such as fraud, self-dealing, making a profit or the like. Scott, *Trusts,* 1939, Section 205.1. In order to deter trustees from committing such breaches of trust liability is imposed in such cases even though there is no causal connection between the breach of trust and the loss. This is as true in New York as it is elsewhere. The present case is clearly not such a case. Here the Court below has decided that the Trustee misinterpreted a trust agreement. The Trustee was guilty of no fraud or bad faith, the releases were not made with the intention of circumventing the trust agreement, the Trustee did not realize any profit or gain from any of the challenged transactions (R. 571-572) and obviously the Trustee was not guilty of self-dealing. In every respect the releases of cash to pay off serially maturing bonds of the Debtor were simply the normal and usual transactions which would have been

unobjectionable but for the minor defaults in installments of principal which were never cured.

The Court below, however, has purported to find in the New York decisions a justification for imposing absolute liability even on a Trustee who has been guilty of only a misinterpretation in good faith of a trust agreement, involving no fraud, self-dealing, or profit to the Trustee. The opinion states (R. 647) that "the New York cases do not provide an explicit underlying rationale which would govern the situation in the instant case", but absolute liability is imposed upon the Trustee notwithstanding. The decision below is in conflict with the New York decisions and with decisions in many other jurisdictions.

The leading case in New York on the question whether a trustee who acts in good faith may be surcharged even though the breach of trust is not the proximate cause of a loss is *Matter of Adriance,* 145 Misc. 345 (Surr. Ct., Kings Co., 1932). A testamentary trustee invested in bonds represented to be secured by a building completed and partly rented. In fact, the building was not built, but it was later completed and the bonds then became a legal investment when they were selling at par. The court refused to surcharge the trustee, because the unauthorized act was not an effective cause of the loss resulting from the later shrinkage in market values resulting from the depression. That case was not appealed but has been consistently followed in many other cases in New York. *Matter of Turner,* 156 Misc. 68 (Surr. Ct., Orange Co., 1935); *Irving Trust Co.* v. *Natica,* 157 Misc. 32 (Sup. Ct., N. Y. Co., 1935); *In re Toel's Estate,* 39 N. Y. S. 2d 898 (Surr. Ct., N. Y. Co., 1943). See also *Matter of Beebe,* ~~N. Y. Law Jour., 3/22/43, p. 1123~~

52 N.Y.S. 2d 736

aff'd. 52 N.Y.S. 2d 796.

(Surr. Ct., Kings Co.) *Matter of Adriance* has never been overruled or criticized by any New York appellate court.

In *Matter of Harris*, 169 Misc. 943 (Surr. Ct., N. Y. Co., 1938), the trustee had failed to earmark securities and kept them in the name of the trustee. The court refused to surcharge the trustee, however, for losses resulting from the depression which bore no relation to the breach of trust. The same result was reached in *In re Kirby's Estate*, 35 N. Y. Supp. 2d 651 (Surr. Ct., Westchester Co., 1942). Again, in *In re First National Bank of City of N. Y.*, 25 N. Y. Supp. 2d 221 (Sup. Ct., N. Y. Co., 1941), the court refused to surcharge a trustee for failure to diversify securities and to follow a regulation of the Federal Reserve Board, when the record failed to establish that either breach was a cause of the loss.

The Court below, however, refused to accept those decisions as it is required to do under *Fidelity Union Trust Co.* v. *Field*, 311 U. S. 169 (1940). It cited (R. 646) cases in which the trustee had been guilty of self-dealing, in which, undoubtedly the rule of absolute liability prevails. It cited (*ibid.*) cases in which the trustee had purchased from itself participating shares in a mortgage without giving the notice to the beneficiaries required by Section 188(7) of the Banking Law—cases which are akin to the self-dealing cases, and in which the investment is plainly illegal unless the notice is given. That is, the statutory notice is the legalization of what would otherwise be self-dealing. *Matter of Bearns*, 251 App. Div. 222 (1st Dept., 1937), aff'd 276 N. Y. 590. And finally the court cited (*ibid.*) cases of illegal investments, where the causal relationship between breach and loss is obvious.

The Court below cited no cases where a trustee has been surcharged, as here, unless he was found guilty of fraud, or self-dealing, or profiting from the breach of trust, or unless there was a causal connection between the breach of trust and the loss to the trust fund or beneficiary. There are no such cases.

The rule established by these New York cases, requiring causal connection between the breach of trust and loss to support a surcharge against a trustee not guilty of fraud, self-dealing, self-enrichment and the like, is not peculiar to New York but has been applied in decisions of the Circuit Court of Appeals of the Sixth Circuit and courts of last resort of eleven states. *Potter* v. *Union & Peoples Nat. Bank*, 105 F. 2d 437 (C. C. A. 6, 1939); *Matter of Darlington*, 245 Pa. 212 (1914); *Chapter House Circle* v. *Hartford Nat. Bank & Trust Co.*, 121 Conn. 558 (1936); *Carey* v. *Safe Dep. & T. Co. of Baltimore*, 168 Md. 501 (1935); *First Nat. Bank of Boston* v. *Truesdale Hospital*, 288 Mass. 35 (1934); *Cox* v. *Camden Safe Dep. & T. Co.*, 124 N. J. Eq. 490 (1938); *In re Lefevre*, 9 Wash. 2d 145 (1941); *Miller* v. *Pender*, 93 N. H. 8 (1943); *Rotzin* v. *Muier*, 134 Neb. 8 (1938); *Voorhies* v. *Blood*, 127 Fla. 337 (1937); *Peoples State Bank* v. *Wade*, 269 Ky. 89 (1937); *First National Bank of Birmingham* v. *Basham*, 238 Ala. 500 (1939).

Indeed, as we have already pointed out, the Court below felt compelled to say (R. 647) that it could find no explicit support in the New York cases for its decision. Actually, its conclusion seems to be rested (*ibid.*) upon a misinterpretation of a quotation from a text book (Scott, *Trusts*, Sec. 205.1), which suggested that absolute liability

is proper if the breach is such that it is necessary to deter trustees from future similar breaches. The Court below misinterpreted this to mean that the Court had discretion in each case to impose absolute liability. Such a doctrine finds no support whatever in any New York decision. Actually, the text-writer was simply advancing a rationale for the rule prevailing both in New York and elsewhere that absolute liability is imposed only in breaches involving such things as fraud, self-dealing, self-aggrandizement, and the like (Scott, *Trusts*, Section 205.1). Nothing in either the text or the New York decisions supports to any degree the conclusion of the Court below that absolute liability may properly be imposed when such factors are absent.

We repeat that no case has been found in New York or elsewhere imposing absolute liability upon a trustee irrespective of causal connection between the breach of trust and the loss in the absence of fraud, self-dealing, self-aggrandizement or the like.

II

The decision below that assignees of bonds who were not holders of the bonds at the time of the breach may maintain this suit is a decision on an important question of New York law in probable conflict with the controlling New York decisions.

Over the objection of the Trustee, the Special Master ruled that Prudence-Bonds Corporation (the New Corporation), the Trustees of the Debtor, and Hilda S. Reese, who purchased her bond in September, 1933 * (R. 550),

* The last release was January 13, 1933 (R. 68).

were entitled to maintain this action, and this ruling was approved by the Court below (R. 643-645). We submit that this ruling on an important question of New York law is contrary to controlling New York decisions.

New York courts have consistently ruled that claims by certificate holders against a depository for permitting allegedly improper withdrawals, releases or substitutions of collateral could not properly be maintained as class actions, but only as individual claims by certificate holders who held their certificates at the time of the alleged breach. *Mittleman* v. *President, etc. of Manhattan Co.*, 248 App. Div. 79, aff'd 272 N. Y. 632 (1936); *Weil* v. *President etc. of Manhattan Co.*, 275 N. Y. 238 (1937); *Hendry* v. *Title Guarantee & Trust Co.*, 255 App. Div. 497, aff'd 280 N. Y. 740 (1939). These cases, in other words, involved wrongs of the same type as those of which complaint is made here. The *Hendry* case, for example, was an action to recover the amount of a condemnation award which had been wrongfully released by the fiduciary.

The Court below, however, refused to accept those cases as authority here on the ground that they involved claims against a depository, as distinguished from a trustee (R. 643-645), following, in this respect, its prior decision in *Manufacturers Trust Co.* v. *Kelby*, 125 F. 2d 650, 652-654 (1942), certiorari denied 316 U. S. 697. Certainly the New York decisions cited above do not enunciate this distinction. And whatever might have been its supposed basis in 1942 when *Manufacturers Trust Co.* v. *Kelby*, *supra*, was decided, subsequent New York decisions have shown clearly that the New York courts do not recognize any such distinction.

In fact, even before 1942, the New York courts indicated that no such distinction existed. In *Elkind* v. *Chase National Bank*, 259 App. Div. 661, aff'd 284 N. Y. 726 (1940), a bondholders' class action was brought alleging that the trustee had obtained payment to itself of certain unsecured loans made by it to the obligor through a subsidiary corporation which had been used to siphon off the profits and good will of the obligor. The Appellate Division dismissed the action, holding that the good will had not been pledged as part of the mortgage collateral, and that the trustee had not itself received any part of the trust assets. The *Hendry* case was there strongly relied upon.

The *Elkind* case shows that even when the *Kelby* decision was handed down, there was some indication that the New York courts made no distinction between depository and trustee cases. In either type of case, actions must be by individual bondholders who held their bonds at the time of the wrong complained of, except only where the fiduciary itself had wrongfully received part of the trust *res*. In this latter case, a representative action would lie to compel the trustee to restore what it had taken.

In the *Kelby* case, the Court below seized upon this exception, and expanded it to permit a representative action in a case in which the trustee had improperly surrendered a part of the *res* but *without itself receiving anything in return*. 125 F. 2d at p. 653. The Court below, as we have indicated, was compelled to make a distinction between a depository and a trustee, since in the *Hendry* case a representative action had been dismissed which involved precisely similar acts by a depository—improper surrender

by the fiduciary of part of the *res* without receipt of anything in return.

The decisions after 1942, however, conclusively refute any such distinction. In two opinions since that time the New York Court of Appeals has cited and discussed depositor cases—especially the *Hendry* case—as being of equal bearing and authority in cases involving trustees. In *Emmerick* v. *Central Hanover B. & T. Co.*, 291 N. Y. 570 (1943), bondholders individually sued the trustee under a mortgage securing a railway bond issue, alleging that a valuable lease had been permitted to become forfeit. The case was dismissed on the pleadings because it was not alleged that plaintiffs were bondholders at the time of the acts complained of. Again, as in the *Elkind* case, the New York Court of Appeals relied upon the *Hendry* case. The *Kelby* case was the only case relied upon in the briefs of the appellant to distinguish the *Hendry* case, and it proved unavailing.

Still more recently, in *Smith* v. *Continental Bank*, 292 N. Y. 275 (1944), the New York Court of Appeals again indicated that, in the New York courts, there was no distinction in this regard between depository and trustee cases. In the *Smith* case, bondholders sued a trustee charging that it had negligently allowed a valuable leasehold, which was a part of the trust *res*, to become forfeit. The complaint alleged that the plaintiffs owned their bonds at the time of the alleged breach, but did not allege that they were bondholders at the time the action was commenced. The Court, reversing the decision below, held that the right of the bondholders to sue was personal and that ownership at the time of the alleged breach was sufficient. In support of its decision the Court cited and

quoted both trustee and depository cases with no indication whatever that they were not equally relevant on this point.

The Court below in the instant case simply refuses to recognize that the distinction which it has attempted to create in the New York law does not exist, and is in fact denied, by these cases. That the New York Court of Appeals in the *Smith* case quotes from and relies upon the *Hendry* case evoked from the Court below only the comment that "the language of the *Smith* case with reference to the *Hendry* case is not pertinent here" (R. 644-645). Since the *Hendry* case unquestionably involves a similar transaction—an improper release of collateral without anything passing to the fiduciary in return—it would certainly seem that the language of the *Smith* case, which involved a trustee, specifically relying upon the *Hendry* case, was of the utmost pertinence—indeed, of controlling weight.

III

The decision below is contrary to the principle that federal courts should encourage or direct state court litigation to determine doubtful state law.

Points I and II, *supra*, reveal that there are two issues involved in this proceeding as to which there is at least substantial doubt as to the applicable state law. As to one issue, the Court below itself admits that it knows of no explicit rationale in the state decisions, and as to the other there is admittedly no direct support for the distinction by which it dismisses otherwise controlling state

decisions. Under such circumstances, we submit that the Court below should have directed or encouraged prompt litigation in the state courts in order to obtain conclusive answers to both questions. *Thompson* v. *Magnolia Petroleum Co.*, 309 U. S. 478 (1940); *Spector Motor Service* v. *McLaughlin*, No. 62, Oct. Term, 1944, December 4, 1944. In the former case, which was also a bankruptcy proceeding, this Court stated that "Unless the matter is referred to the state courts, upon subsequent decision by the Supreme Court of Illinois it may appear that rights in local property of parties to this proceeding have—by the accident of federal jurisdiction—been determined contrary to the law of the State, which in such matters is supreme" (p. 484). The reason is equally valid here.

There has been one attempt at state court litigation of the issues. That action was enjoined and the injunction affirmed by the Court below, because the joinder there, as defendants, of both petitioner and the objectors in the instant case might have resulted in a judgment interfering with the exercise of jurisdiction by the bankruptcy court and because the complaint did not adequately present the issues. *Brooklyn Trust Co.* v. *Kelby*, 134 F. 2d 105 (1943), certiorari denied, 319 U. S. 767. The *Thompson* case was not cited either to the Court below or in the petition for certiorari. Moreover, both objections to that state court suit can readily be avoided; neither is a fundamental bar to the state court litigation of the basic questions here involved.

The sound policy which led this Court to direct the Federal courts in the *Spector Motor Co.* and *Thompson* cases to withhold judgment until state law could be

determined by state court litigation, seems even more clearly applicable here. In those cases, the Federal courts could at least have given an answer which would not have jeopardized the parties in the future. Here, however, petitioner is subject to action in the state courts of New York by bondholders who may have sold their bonds, as in the *Smith* case, *supra*, with no assurance whatever that the New York courts will accept as state law the holdings of the Court below.

CONCLUSION

The decision below is not only of major concern to petitioner, faced as it is with a tremendous surcharge for a good faith misinterpretation of a complex trust agreement, but it is also of far reaching effect on all fiduciaries. Collateral trust funds of this character are numerous and there are a vast number of them in existence in New York. The decision below, which certainly breaks new ground, must necessarily affect the performance and responsibility of fiduciaries under these agreements. Moreover, since there are now pending several other proceedings involving other trustees under other trust agreements with the Debtor in which the same issues are involved, a determination by this Court now will obviate the need for much future litigation.

Wherefore, your petitioner respectfully requests that writs of certiorari to the Circuit Court of Appeals for the Second Circuit should be granted.

February 28, 1945.

President and Directors of the Manhattan Company,
Petitioner.

By
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

Nos. 1001, 1002

PRESIDENT AND DIRECTORS OF THE MANHATTAN COMPANY,
Petitioner,
against

CHARLES H. KELBY, CLIFFORD S. KELSEY, Trustees of the Debtor, PRUDENCE-BONDS CORPORATION (New Corporation), GEORGE E. EDDY, HILDA S. REESE, LEOPOLD HELFANT, SARAH HELFANT and SAMUEL PLASSER.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRITS OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

Nos. 1001, 1002

President and Directors of The Manhattan Company,
Petitioner,
against

Charles H. Kelby, Clifford S. Kelsey, Trustees of the Debtor, Prudence-Bonds Corporation (New Corporation), George E. Eddy, Hilda S. Reese, Leopold Helfant, Sarah Helfant and Samuel Plasser.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRITS OF CERTIORARI

Opinions Below

The Reports of the Special Master (5 R. 519; 9 R. 460) and the opinion of the District Court (R. 617) are reported in 57 F. Supp. 839. The opinion and supplemental opinion of the Circuit Court of Appeals (R. 632, 655) are not as yet reported.*

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* There are two companion cases, with separate records on appeal, one of which is designated as "Fifth Series" and one as "Ninth Series". A separate Report was made in each case by the Special Master before whom the cases were tried, and a separate decree was made in each case. One opinion was written by the District Court Judge. The opinion and supplemental opinion of the Circuit Court of Appeals cover both cases.

Unless otherwise indicated, the references are to the Fifth Series record. References to the separate records are indicated by the figures "5" or "9" preceding the letter "R", as for example ("5 R. 100").

Jurisdiction

The opinion and supplemental opinion of the Circuit Court of Appeals were rendered on December 18, 1944, and February 2, 1945 (R. 632, 655). The orders for the mandates thereon were entered on February 16, 1945 (R. 657).

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Sec. 347).

Questions Presented by Petitioner

As we shall show, there is no basis whatsoever for the assumption of fact which petitioner makes in its first question; namely, that the violations of the two Trust Agreements for which petitioner has been surcharged were merely "technical" breaches of trusts which resulted in "no loss to the trust fund or beneficiaries". The Courts below have found that petitioner, as Trustee of express trusts, released and disbursed cash and securities from the Trust Funds in violation of the express provisions of the Trust Agreements, resulting in a depletion of each Trust Fund in the amount of the respective surcharges.

By its second question, petitioner seeks to present an issue, which, as we shall show, was the subject of two prior petitions for certiorari in this same proceeding, each of which was denied.

The third question presented by petitioner assumes the validity of the contentions it advances under questions "1" and "2".

Preliminary Statement

The case involves an accounting in a bankruptcy proceeding by petitioner as Trustee under two Trust Agreements, each securing a Series of the Debtor's bonds, and,

on its accounting, petitioner has been surcharged for acts not authorized by the Trust Agreements.

Petitioner's statement of the case is incomplete and importantly inaccurate. It sets forth petitioner's version of the "fundamental scheme of the trust agreement", and then states (p. 6), that "Despite these facts", the District Court approved the Reports of the Special Master and surcharged petitioner over a million dollars, and that the Circuit Court of Appeals concurred, with certain modifications which increased the surcharges.

What petitioner has failed to make clear is that all of the Courts below have rejected its contentions with respect to the interpretation of the Trust Agreement. The Courts below have rejected petitioner's contention that the Trust Agreement permitted it to do the acts for which it has been surcharged. The Courts below have rejected petitioner's contention that the Trust Funds suffered no loss as a result of its acts, because, as the petitioner contends, the "fundamental scheme of the trust agreement" was that the Debtor had the unrestricted right to use Trust Fund monies as a "revolving fund" to pay its serially maturing bonds, irrespective of the condition of the mortgage collateral in the Trust Funds. The Courts below also have rejected petitioner's contention that, under the Trust Agreement, the only persons who can complain about its unauthorized acts are the bondholders who owned a bond or bonds on the date or dates the acts were committed. And yet, the petitioner states that (p. 8): "By this petition a review is not sought of the proper interpretation of the trust agreement, although we believe the decision below was erroneous."

It will at once be apparent to this Court that the kind of review sought by the petitioner cannot be granted. Petitioner, it would appear, seeks to have this Court ignore the Trust Agreement and review the questions it presents, upon the assumption that its version of the trust instrument is correct, notwithstanding the findings of the Courts below to the contrary.

Petitioner, as we shall show, also would like to disregard the Trust Agreement so as to bring itself within cases involving tort claims against depositaries of mortgage certificate issues, which, unlike the bond issues here involved, were issued without a trustee or trust agreement and did not involve a relationship of trustee and *cestui que trust*.

Statement

The two decrees modified and affirmed as modified by the Circuit Court of Appeals were made by the bankruptcy court in the proceeding for reorganization of Prudence-Bonds Corporation, Debtor, under Section 77B of the Bankruptcy Act (R. 630). These decrees confirmed Reports of a Special Master (5 R. 519; 9 R. 460), surcharging petitioner on its accounting in the reorganization proceeding for its acts as Trustee under two Trust Agreements, each securing a Series of the Debtor's bonds, one of which is known as "Fifth Series", the other as "Ninth Series" (5 R. 11; 9 R. 12).

When the Debtor petitioned for reorganization it had outstanding eighteen Series of First Mortgage-Collateral Trust Bonds; each secured by a separate Trust Agreement and Trust Fund consisting of bonds and mortgages, cash and other securities (R. 521, 540-541, 544). In the course of the proceeding, the Debtor was found to be insolvent (R. 545). The Prudence Company, Inc., the Guarantor of the Debtor's bonds, also petitioned for reorganization and it also was found to be insolvent (R. 543). A General Plan of Reorganization of the Debtor herein and a separate Plan for each Series of its bonds were duly confirmed (R. 545-546); the bankruptcy court reserving jurisdiction to carry out the Plans (R. 498-499, 501(a)-502).

The General Plan provided in part for the formation of a New Corporation to be wholly owned by the bondholders (R. 546). The separate Series Plans provided for Modified or Supplemental Trust Agreements (R. 546).

As part of the proceedings to make effective, consummate and carry out the Plans, the bankruptcy court approved the Supplemental Trust Agreement, appointed one of the Corporate Trustees as Successor Trustee for all Series of bonds, authorized and directed each of the old Corporate Trustees under the original Trust Agreements (including petitioner) to transfer and deliver the Trust Funds to the Successor Trustee and to account in the reorganization proceeding for its acts as Trustee (R. 504-506, 508-509). Each of the Supplemental Trust Agreements (R. 513), as the Circuit Court of Appeals pointed out in *Brooklyn Trust Co.* v. *Kelby*, 134 F. 2d 105, 108-109, cert. den., 319 U. S. 767 (a prior appeal in the proceeding), provided, at the instance of the Successor Trustee, that the Successor Trustee "should 'not be required to institute any actions, legal or equitable, against any of its predecessors as trustees under the original trust agreement'."

The old Corporate Trustees accordingly filed their accounts and respectively petitioned the bankruptcy court for a judicial settlement thereof (R. 548).

The jurisdiction of the bankruptcy court over the accounts was upheld in *Central Hanover B. & T. Co.* v. *President and Directors of the Manhattan Company*, 105 F. 2d 130, and the court thereupon retained and exercised jurisdiction to make effective and carry out the Plans (R. 515). Objections to the accounts were filed and the accounts and objections were referred to a Special Master for trial (R. 549, 125). There then ensued further litigation in the proceeding, which is described in the other two earlier opinions of the Circuit Court of Appeals, which are reported as *Manufacturers Trust Co.* v. *Kelby*, 125 F. 2d 650, cert. den., 316 U. S. 697, and *Brooklyn Trust Co.* v. *Kelby, supra*, each of which involved the same issue petitioner here seeks to review by its second question.

In September, 1938, petitioner, as Trustee of the Fifth and Ninth Series bonds, under Trust Agreements with the Debtor, dated April 1, 1925 and March 1, 1927, respectively (5 R. 310; 9 R. 289), filed its accounts and a petition

for the judicial settlement thereof* (5 R. 18, 28-83; 9 R. 19, 29-69). Objections on behalf of the bondholders were timely filed by the Debtor's reorganization Trustees, the bondholders' own New Corporation and by individual bondholders (5 R. 83-124; 9 R. 69-95). A protracted trial of the objections was had before the Special Master (R. 130, 299).

So far as here material, the objections charged that the petitioner, as Trustee, released to the Debtor large sums of cash and other securities in violation of the express provisions of the respective Trust Agreements. The relief sought against petitioner was that it be surcharged and compelled to replenish and restore the Trust Funds to the extent it had depleted them in violation of the Trust Agreements. No individual recoveries were sought by any Objector; the objections being made "derivatively and for the benefit of the respective trust funds" (*Brooklyn Trust Co.* v. *Kelby, supra,* at p. 109).

The Master in separate Reports recommended that certain of the objections be sustained with surcharges against the petitioner of $1,065,565 in the Fifth Series and $148,-199.99 in the Ninth Series; that other objections be dismissed, and that upon payment of the surcharges the petitioner individually would be entitled to certain subordinated liens on the respective Trust Funds, as well as to the proceeds of a certain Ninth Series mortgage of $12,500, which the Master found petitioner had accepted in lieu of cash it should have received (5 R. 572-575; 9 R. 505-507).

The surcharges recommended by the Master cover objections, which he sustained, to petitioner's acts, as Trustee, in releasing to the Debtor on various dates, a bond and mortgage (herein designated as "B&M 5-559") in the principal sum of $115,600, and a total of $1,085,664.99 of

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* As the Circuit Court of Appeals noted, "None of the old corporate trustees ever objected to the order to account". Indeed, until it was indicated that their accounts would be objected to they all had "been eager for a complete adjudication, in the bankruptcy proceedings, of their respective liabilities" (*Brooklyn Trust Co.* v. *Kelby, supra,* at pp. 108, 109).

Trust Fund cash, and in accepting the above mentioned $12,500 mortgage in lieu of cash (5 R. 572-575; 9 R. 505-507).* The entire sum of cash was collateral cash or part of the principal of the Trust Funds (5 R. 51, 58; 9 R. 49, 54). According to petitioner's own accounts nothing was received into the Trust Funds in exchange or in substitution for B&M 5-559 or for the $1,085,664.99 of cash which petitioner released; the accounts averring that B&M 5-559 and a total of $911,715.01 cash were released as "Excess Collateral", and that the balance of cash, totaling $173,-949.98, was released in exchange for bonds of the Series delivered to petitioner for cancellation (5 R. 49, 37, 56, 64-68; 9 R. 58-60).

It was stipulated and found by the Master that on the date of the release of B&M 5-559, on the respective dates of each of the aforesaid releases of cash, and at all times thereafter, one or more bonds and mortgages in the Trust Funds were in default in the payment of principal (5 R. 84-88, 97-116, 561-568; Objectors' Ex. 13, 5 R. 149, 424-426; 9 R. 71-73, 82-89; Objectors' Ex. 15, 9 R. 116, 357-359 **). The Master also found that in permitting these releases of Trust Fund collateral the petitioner acted deliberately and with knowledge of the defaults in the underlying mortgage collateral (5 R. 532, 535, 568; 9 R. 476, 500-501).

* B&M 5-559 was released from the Fifth Series Trust Fund on December 19, 1931 (R. 49) and $949,965 cash was released between July 20, 1931 and January 13, 1933 (R. 64-68). $135,699.99 cash was released from the Ninth Series Trust Fund between September 25, 1931 and January 13, 1933 (R. 58-60). The $12,500 mortgage was accepted into the Ninth Series Fund on October 31, 1932 (R. 37).

** The voluminous Schedules annexed to the stipulations of fact, which are in evidence as Objectors' Ex. 13, Fifth Series (R. 424-426) and Objectors' Ex. 15, Ninth Series (R. 357-359), are not printed in the records on appeal, but copies were separately handed up to the Circuit Court of Appeals (5 R. 622; 9 R. 545), and we understand they have been filed in this Court, together with several other voluminous Exhibits, which are part of the records.

The amount of the mortgage collateral in the Trust Funds in default in the payment of principal at the times of the releases was substantial and by no means "trivial" or "minor" as suggested by the petitioner. The stipulation of facts evidencing these defaults in the Fifth Series shows that, on one of the dates of the releases of cash, the principal amount of mortgages in default in the payment of principal was $46,920, on one other date it was $86,420, on three dates it was $143,200, on one date $231,652.17, and on the date of the release of B&M 5-559 and on each of the other 38 dates on which petitioner released large sums of Trust Fund cash, the total amount of mortgages in default in the payment of principal ranged from $666,535 to $2,134,485; the average amount of defaulted collateral during the period of these releases being in excess of $1,200,000 (5 R. 97, 106-117; Objectors' Ex. 13, R. 149, 424). As the Master expressed it, with respect to the release of B&M 5-559 as "excess collateral" on a day when over three-quarters of a million dollars of mortgages in the Trust Fund were so in default, the Trust Fund "was and continued to be in wretched condition" (R. 531).

The situation of the Ninth Series Trust Fund was almost as bad. The amount of mortgages in default in the payment of principal on each of the eighteen dates during which the petitioner released a total of $135,699.99 of Trust Fund cash ranged from $248,850 to $783,558.34; the average amount of defaulted collateral during the time of these releases being in excess of $450,000 (9 R. 86-89; Objectors' Ex. 15, R. 116, 357).

On the date of each of the releases which the Master held unauthorized, the aggregate principal amount of the respective Trust Funds, less the principal amount of mortgages in default, was substantially less, than the total prin-

cipal amount of bonds outstanding * (Objectors' Ex. 15, 5 R. 157, 427; Objectors' Ex. 23, 9 R. 130, 379).

Indeed, the cash which petitioner released without receiving anything in substitution and at times when a substantial part of the respective Trust Funds was in default, included a total of $170,891.66 cash released by petitioner to the Debtor after the respective dates of the Debtor's default in the payment of the principal of its bonds (5 R. 66-68, 543; 9 R. 58-60, 501).

The Master ruled that the Trust Agreement (Sec. 6, Art. I; 5 R. 317; 9 R. 254) expressly prohibited petitioner, as Trustee, from permitting any substitutions or withdrawals of non-defaulted Trust Fund collateral, including cash, if and as long as any mortgage collateral ** in the Trust Fund was in default in the payment of principal (5 R. 526-527, 532-533, 553-554; 9 R. 467-468, 472-473, 493-495). The Master further held that the Trust Agreement (Sec. 6, Art. I), prohibited the release of any Trust Fund collateral unless the aggregate amount of non-defaulted collateral remaining in the Trust Fund after any release at least equaled the principal amount of the bonds outstanding at the time (5 R. 531, 553-555; 9 R. 467, 493-495).

The District Court confirmed the Master's Reports, overruled the exceptions thereto, and awarded judgments

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* In its main opinion, the Circuit Court of Appeals gave petitioner the opportunity of filing a further brief to show, if it could, whether on any of the dates in question the Trust Fund, as thus computed, at least equaled the bonds outstanding (R. 641). In the brief, which it filed pursuant to such permission, the Trustee attempted to show that such was the case on only one date when it released some $42,500 cash (5 R. 64); the petitioner contending that as of such date there was approximately $30,000 available for release. In its supplemental opinion, the Circuit Court of Appeals held that the method of calculation by which the petitioner attempted to make such showing was not justified by the Trust Agreement (R. 655).

** The words mortgage collateral are herein used generally to describe the kind of collateral referred to in Section 6 of Article I of the Trust Agreement as "bonds, mortgages or other securities deposited under paragraphs (a), (b) and (c), Section 1 of this Article" (5 R. 317, 312-313; 9 R. 254, 249-251).

against the petitioner in favor of the New Corporation for the benefit of the respective Trust Funds; each decree providing that, upon payment of the surcharge, petitioner's account, as adjusted, be judicially settled, that petitioner be discharged from all further liability, and that all persons be perpetually restrained from suing it with respect to its acts as Trustee (5 R. 14-16; 9 R. 14-18).

On cross-appeals, the Circuit Court of Appeals, in the decision here sought to be reviewed, modified and affirmed as modified the decrees below by increasing the surcharges by a total of $12,808.36, under an objection which had been dismissed below,* and by holding that interest should have been allowed on all surcharges at a rate to be fixed by the trial Judge (R. 630).

The Trust Agreement

The Fifth Series Trust Agreement is the same as the Ninth Series Trust Agreement (5 R. 310; 9 R. 248); each created an express trust (*Manufacturers Trust Co.* v. *Kelby, supra*).

Each agreement is therein described as a "Trust Agreement" (R. 310). It recites that the Debtor "has determined to establish a Trust Fund" to secure the payment of the bonds "at any time issued and outstanding" (R. 310-311). It "Witnesseth" that the Debtor "has granted, bargained, sold, assigned, transferred and set over" the Trust Fund to the Trustee "to have and hold * * * upon the trusts hereby created for the equal and pro rata benefit and security of the holders of Prudence-Bonds, Fifth Series, issued and to be issued hereunder and to secure the payment of the principal and the interest of said bonds, and for all the other uses and purposes and upon the terms and conditions herein declared and expressed."

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* The Third objection in the Fifth Series involving $8,050 and the Fourth objection in the Ninth Series involving $4,758.36 (5 R. 89; 9 R. 75; 5 R. 653-654).

(R. 311). It then provides that the Trust Fund "shall be for the equal and pro rata benefit and advantage" of the holders of the bonds "at any time issued and outstanding under this agreement, irrespective of the date of the assignment to and deposit with the Trustee of the securities and cash constituting same" (R. 311-312). It further provides that all bonds "issued under this agreement shall be * * * secured by the Trust Fund irrespective of the actual date of their issuance and negotiation" (R. 320), and that the Trustee's certificate of authentication on the bonds "shall be conclusive evidence that the bond so authenticated has been duly issued hereunder and is entitled to the benefit of the trusts hereby created" (R. 325).

Article I, Section 4, provides that the total amount of the Trust Fund should not exceed $5,000,000 (R. 315). Article II, Section 1, provides that the total amount of bonds outstanding should not exceed the principal amount of the Trust Fund and should not exceed $5,000,000 (R. 320). Five different classes of eligible securities are provided for in paragraphs (a), (b), (c), (d) and (e) of Section 1, Article I (R. 311-313). Paragraphs (a), (b) and (c) securities (herein called "mortgage collateral") comprised, (a) bonds secured by first mortgages on income-producing real estate, (b) bonds and notes forming all or part of a series of similar obligations secured by first mortgages or deeds of trust made to corporate trustees, and (c) Prudence-Bonds of other Series and first mortgage certificates (R. 312-313). Paragraph (d) securities comprised bonds and other securities legal for New York State savings banks, and paragraph (e) embraced cash, certificates of deposit, United States bonds or Treasury certificates and bonds of the City or State of New York (R. 313).

Article II, Section 1, provides for the issuance of bonds in varying denominations with maturities coinciding with

any interest payment date * (R. 320). There were, however, express limitations upon the right to issue and authenticate bonds. Article II, Section 2, authorized authentication only when the Trust Fund consisted of mortgage collateral maturing during the six months' period immediately preceding or the three months' period immediately following and including the maturity date of the bonds to be authenticated, which, together with cash and (d) and (e) securities, at least equaled the principal amount of bonds to be authenticated and all outstanding bonds of the same maturity date (R. 325). As the Circuit Court of Appeals held, "Obviously it was the intent that Corporation bonds could not be issued in amounts not matched by cash or (d) or (e) securities, plus face amount of (a), (b) and (c) securities 'maturing during the six months' etc., and which were not in default." (R. 636).

Article I, Section 6, which expressly restricts substitutions and withdrawals of cash and other securities, contains, among others, a similar restriction designed to prevent any interference with the liquidity of the Trust Fund required to be established upon the authentication of bonds (R. 524, 636).

Thus, while all securities and cash in the Trust Fund were security for all bonds, additional security and protection were provided by the limitations upon the authentication of bonds and upon substitutions and withdrawals of collateral. Two definite controls were set up and at the most logical places: 1) at the point where the collateral came into the Fund, and 2) where it might be withdrawn. By these limitations, the Fund was established so that it would be liquid; as the bonds matured, either mortgage collateral would mature, or there was to be in the Fund cash or marketable (d) and (e) type securities in an amount at least equal to the matured bonds (R. 526).

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* April 1st and October 1st in the Fifth Series (Objectors' Ex. 15, R. 157, 427). March 1st and September 1st in the Ninth Series (Objectors' Ex. 23, R. 130, 379).

The assumptions made by the petitioner in its statement, as to the "fundamental scheme of the trust agreement", the alleged "revolving nature" of the Trust Fund, and as to how the Debtor was "expressly permitted" to "secure its effective operation as such a revolving fund", find no support in the Trust Agreement. They have all been rejected by the Courts below. The plain purpose of the Trust Agreement was to create a Trust Fund to secure payment of all bonds equally and *pro rata*, and not a Fund which the Debtor could freely use to pay bonds as they matured, irrespective of the condition of the trust collateral. The Courts below have found that the Trust Agreement required the Trust Fund to be locked up against withdrawals by the Debtor, or "frozen" as the Master expressed it, if and as long as mortgage collateral in the Fund was in default in the payment of principal and while the total principal amount of non-defaulted collateral was less than the total amount of bonds outstanding (R. 526, 619, 634-638).

To bolster its erroneous assumption that there were no limitations upon the Debtor's right of access to Trust Fund cash, the petitioner makes the misleading statement (p. 4) that "the trust agreement expressly permitted the Debtor to collect and retain interest and principal upon the collateral (R. 316) for the purpose of enabling the Debtor to use such proceeds to pay off its bonds". The record reference which petitioner gives to support this statement is Fifth Series record "(R. 316)", which is Section 5 of Article I of the Trust Agreement. But that section expressly and clearly provides that the Debtor's right to collect and retain interest on and principal of the Trust Fund collateral is "subject to the provisions of paragraph (i), Section 1, Article III hereof" (R. 316). Under that paragraph the Debtor was required, on or before the tenth day of each month, to account to the Trustee for all *principal* it had collected during the preceding month, to furnish the Trustee with a statement of such collections, and to

pay over to the Trustee the full amount collected either in cash or its equivalent in the readily marketable high grade type of securities authorized for deposit in the Trust Fund under "paragraph (e), Section 1, Article I hereof" (R. 332, 313).

Thus Section 5 of Article I and Section 1(i) of Article III evidence the fact that the Debtor was authorized to collect and retain *interest collections* on the collateral, so that it might use such collections to pay *interest* on its bonds. But the express requirement that the Debtor had to make a monthly accounting to the Trustee for all *principal* collections and therewith deliver the amount collected to the Trustee "to be held by it as part of the Trust Fund" (R. 332), completely disproves petitioner's statement to the effect that the Debtor had the unrestricted right to use the *principal* collections on the Trust Fund to pay the *principal* of its bonds. And although the Debtor, under Section 1(i), Article III, had a right to turn in bonds of the Series for cancellation in lieu of principal collections, that right, as the section provides and as the Circuit Court of Appeals held, "applies only to bonds maturing 'within six months after the date' of a monthly statement, and does not include bonds which matured on or before that date." (R. 640-641). The Circuit Court of Appeals also held that the "paramount intention of the trust agreement" negated petitioner's contention that the Debtor could have circumvented the prohibitions against the release of Trust Fund cash, as contained in Section 6 of Article I (R. 317), by retaining principal collections and delivering bonds for cancellation in lieu thereof (R. 641).

The petitioner, as previously noted, does not seek a review of these or of any other rulings of the Courts below with respect to the interpretation of the Trust Agreement.

POINT I

Petitioner has not been surcharged for "technical" breaches of trust resulting in "no loss to the trust fund or beneficiaries", as it assumes in its first question.

The foregoing statement of facts conclusively shows that petitioner's first question does not merit a review by this Court. The facts do not support the assumption of fact which petitioner makes in its question, namely, that it has been surcharged "for a technical breach of trust * * * even though no loss to the trust fund or beneficiaries resulted from the breach." (p. 2).

Petitioner argues that, "As the statement, *supra*, indicates, the Court below has ruled that the Trustee is surcharged despite the absence of any causal relationship between the acts of the Trustee and the loss to the trust fund." (p. 8). The fact, however, is that the Court below made no such ruling. Indeed, petitioner has carefully so worded the sentence just quoted as to avoid stating as a fact that the Court below has so ruled. It has said, "As the statement, *supra*, indicates, the Court below" has so ruled.* But, as we have demonstrated, petitioner's "statement, *supra*" is incomplete and importantly inaccurate.

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* Petitioner's technique of statement is like that used in the fictitious state court action which Brooklyn Trust Company (Trustee of the Debtor's Eighth Series of bonds) instituted against petitioner, as Trustee of the Fifth Series, in an attempt to circumvent the decisions of the bankruptcy court and to obtain a determination of their respective liabilities, as Trustees, satisfactorily to themselves. The bankruptcy court enjoined that action and its order was upheld in *Brooklyn Trust Co. v. Kelby, supra;* the Circuit Court of Appeals stating, that petitioner "as defendant, wanted to lose the case on the issue as to whether a former owner of a bond, as distinguished from a present holder, could recover" (the issue petitioner seeks to present here under its second question); that "Brooklyn, as plaintiff in that state court suit, has carefully so worded the complaint that the issues involved in the action against Manhattan in the bankruptcy court are not at all adequately stated"; and that "the issues are misleadingly narrowed and artificially presented" (134 F. 2d 117, 118, 119).

It sets forth a version "of the fundamental scheme of the trust agreement" which is wholly contrary to the interpretation which the Courts below have held must be given to the trust instrument in view of its express provisions and "dominant purpose" to secure the bonds equally and *pro rata* (R. 634-642). And petitioner's statement of the case fails clearly to indicate the nature of the acts for which it has been surcharged.

This is an accounting proceeding and the petitioner, as Trustee, has asked the Court to approve its account. It charges itself with the securities and cash it has received and asks credit for the securities and cash it has released or disbursed (5 R. 33-81; 9 R. 34-67). The case has been determined as it "must be determined upon principles applicable to such an accounting, and not by the measure of damages which might obtain in an action at law. The defendant (trustee) must account for all monies or properties received, and is entitled to credit only for proper outlays." (*Lewis* v. *Ingraham*, 57 F. 2d 463, 466, cert. den., 287 U. S. 614; see also, 65 *C. J.*, Trusts, Sec. 802). The purpose of the accounting is to ensure the delivery to the new Trustee of all cash and securities which should have been in the Trust Funds (*Brooklyn Trust Co.* v. *Kelby*, *supra*, at p. 111). And, on the accounting, it has been determined that petitioner disbursed or released from the Trust Funds a $115,600 mortgage and $1,085,664.99 cash, in violation of the express provisions of the Trust Agreement and without receiving anything in return. The amount of loss to the Trust Funds is clear.

The petitioner's own account shows that the $115,600 mortgage (B&M559) was released as excess collateral and that nothing was substituted or put back into the Trust Fund to take its place (5 R. 49, 37, 56). The same is true of the cash. $911,715.01 cash was released as "Excess Collateral" and $173,949.98 cash was released in exchange for

bonds of the Series delivered to petitioner for cancellation (5 R. 64-68; 9 R. 58-60). The Trustee received no securities in place of or in exchange for the cash.*

The only way, therefore, that the Trust Fund can now adequately and fully be restored is, as the Courts below have held, by requiring the Trustee to put back in the Fund the equivalent of the security and cash it released in violation of the Trust Agreements. If this $115,600 mortgage and the $1,085,664.99 cash could be followed into the hands of the Debtor, there could be no doubt that the bondholders could compel the Debtor to restore the mortgage and cash to the Trust Funds. The wrongfully disbursed trust property, however, cannot now be so followed and the bondholders are pursuing their alternative remedy of holding the Trustee liable for the loss to the Fund. The amount of the loss is no less merely because the liability therefor is the Trustee's rather than the Debtor's. The mere fact that petitioner did not dissipate these trust assets for its own profit does not in any way mitigate the loss sustained by the Trust Funds (*Manufacturers Trust Co.* v. *Kelby, supra*).

Petitioner, stressing its good faith as a reason for granting certiorari (p. 19), states (p. 5), that it "believed in good faith" that it was entitled to release cash to the Debtor irrespective of whether the underlying collateral was in default. The Master stated that "no bad faith will be found. The Bank exceeded its powers in returning the collateral in question, and in so doing, acted deliberately.

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* The complaint in the above mentioned fictitious state court action discussed in *Brooklyn Trust Co.* v. *Kelby, supra*, charged that when petitioner (defendant in that action) released cash or securities "there were substituted cash or securities 'equal in amount or value' to those withdrawn" (134 F. 2d 117). The Trustee's own accounts in the instant case conclusively show that no cash or securities were substituted for the $115,600 mortgage or for any of the $1,085,664.99 cash released (5 R. 49, 37, 56, 64-68; 9 R. 58-60).

It is a matter of no consequence whether it did so carelessly or painstakingly." (R. 535). But the record contains no evidence as to what petitioner "believed in good faith". As the Circuit Court of Appeals noted, "the Bank called none of its employees as witnesses to explain its conduct" (R. 643, note "10"). The Master found that petitioner "was guilty of no fraud in committing the acts complained of" (R. 572). The Circuit Court of Appeals saw no reason "not to accept" this finding, and held: "However, we also agree with him (the Master) that this fact does not exculpate the Bank for release of trust funds in violation of the trust agreement." (R. 641).

Petitioner contends here, as it contended in the Courts below, that the Trust Funds suffered no damage because (p. 6): "All of the releases of cash to the Debtor for which the Trustee was surcharged were in reimbursement for bonds paid off * * * or in exchange for such bonds". Petitioner also states that (p. 6): "The releases of excess collateral were made possible because, during the same period, the Debtor paid off and the Trustee cancelled, serially maturing bonds in an amount substantially in excess of cash released".

Here again petitioner has carefully worded its statements so as not to reveal the true facts. The quoted statements are designed to convey an impression with respect to all collateral released, but actually they are limited so as to refer only to the cash releases in the Fifth Series. They omit to embrace the unauthorized releases of cash from the Ninth Series Trust Fund and omit to include the $115,600 mortgage which was released from the Fifth Series Fund, as excess collateral, during the same period of time in which the cash was released. The undisputed fact, evidenced by petitioner's own accounts, is that the total amount of collateral wrongfully released from the two Trust Funds, namely, $1,201,264.99 (the $115,600 mortgage, plus cash of $1,085,664.99), exceeds the total amount

of bonds cancelled during the period of the releases by $106,373.35.*

Moreover, the record does not support petitioner's suggestion that the cash it released was used by the Debtor to pay off the bonds which it delivered to the petitioner for cancellation. The record shows that petitioner released the trust fund cash for which it has been surcharged (5 R. 64-68; 9 R. 58-60), it shows that some bonds were cancelled during the period of these releases of cash (5 R. 79-80; 9 R. 65-66), but it contains no evidence as to what happened to the cash after it was handed over to the Debtor. Indeed, petitioner's own accounts show that of the $1,085,664.99 cash it released and for which it has been surcharged, $911,715.01 cash was released as "Excess Collateral" and that only $173,949.98 cash was released in exchange for bonds delivered to the petitioner for cancellation (5 R. 64-68; 9 R. 58-60).

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* The unauthorized releases of cash in the Fifth Series were made by the petitioner between July 20, 1931 and January 13, 1933, and total $949,965 (R. 64-68, 572-573). The $115,600 mortgage (B&M 559) was released on December 19, 1931 (R. 49, 572). These releases total $1,065,565. In the same period of time, $1,024,500 principal amount of Fifth Series bonds were cancelled (R. 78-80). Of this total, $8,200 of bonds were delivered to the Trustee for cancellation in lieu of delivering $8,050 cash, which the Debtor had collected on account of principal of mortgages in the Trust Fund (R. 536). In the same period of time, $11,600 of bonds were authenticated (R. 74-75). Thus, in this period of time, the collateral released from the Fifth Series Trust Fund exceeded the net amount of bonds cancelled by $60,715.

The unauthorized releases of cash in the Ninth Series were made between September 25, 1931 and January 13, 1933, and total $135,699.99 (R. 58-60, 505-506). In the same period of time, $101,100 principal amount of Ninth Series bonds were cancelled (R. 65-66). Of that total, $5,300 of bonds were delivered to the Trustee for cancellation in lieu of $4,758.36 cash which the Debtor had collected on account of principal of Ninth Series mortgages (R. 477). In the same period of time, $6,300 of bonds were authenticated (R. 63; Objectors' Ex. 23, Sch. II, p. 4; R. 130, 379). Thus, in this period of time, the cash released from the Ninth Series Fund exceeded the net amount of bonds cancelled by $45,658.35.

To support its argument based upon the cancellation of bonds, petitioner makes another misstatement of fact. It states (p. 8): "The Special Master held that amounts released before June 30, 1931—the last clear day—resulted in 'no ascertainable diminution of the trust fund' (R. 530). This was because the releases had been accompanied by corresponding reductions in the amount of outstanding bonds".

The Master made the ruling to which the petitioner refers (R. 532), but his reason for such ruling is not as stated by petitioner. His ruling is not based upon the fact that the releases had been accompanied by a corresponding reduction in the amount of outstanding bonds. The basis of the Master's ruling, in this respect, is that subsequent to the dates of all releases occurring before June 30, 1931, the Trust Fund was "restored to its lawful state; a sufficient amount of eligible and liquid securities matched the outstanding Prudence-Bonds." (R. 529-530). In other words, the Master found that subsequent to the times of these releases there came a time when the Trust Fund was "sweet" or completely free of defaulted mortgage collateral (R. 529-530, 532). But, as he also found, the last of any such dates was June 30, 1931 (R. 530, 532), and that from and after such date the Trust Fund should have been "frozen", because "mortgages constituting part of the collateral were, and continued to be in default in the payment of principal." (R. 561).*

Thus, petitioner's argument that the Trust Funds suffered no loss because bonds were cancelled is made in disregard of the facts averred in its own accounts. Petitioner, in making this argument, also fails to mention the fact that the Trust Agreement, as the Courts below have

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* In the Ninth Series, the Master found that the last of any such dates was September 1, 1931 (9 R. 471-472) and that from and after that date "mortgages * * * were, and continued to be in default in the payment of principal." (9 R. 498).

held, prohibited the petitioner from releasing cash and other securities against the cancellation of bonds while mortgage collateral was in default in the payment of principal (R. 524-525, 535, 634-635). And the argument completely ignores the fact that the Trust Fund assets which petitioner wrongfully released were security, not alone for the bonds it cancelled, but for all the bonds now outstanding (R. 310-312, 320). All of the cash which petitioner released and for which it has been surcharged represented the proceeds of mortgages which were in the respective Trust Funds on the date of the first of such releases (5 R. 37, 46-47, 49, 56-57, 64-68; Objectors' Ex. 15, R. 157, 427; 9 R. 37, 44-46, 52-54, 58-60; Objectors' Ex. 23, R. 130, 379). Those mortgages constituted part of the security for the bonds now outstanding and the cash proceeds thereof should have remained in the respective Trust Funds.

The principle is well established, in New York and elsewhere, that a creditor may not be required to surrender any part of his security until the debt has been paid in full (*McGrath* v. *Carnegie Trust Co.*, 221 N. Y. 92; *Evertson* v. *Booth*, 19 Johns. (N. Y.) 486; *People* v. *Remington*, 121 N. Y. 328; *Lamar L. & C. Co.* v. *Belnap Sav. Bank*, 28 Col. 344, 64 Pac. 210; *Goepper & Co.* v. *Phoenix Brewing Co.*, 115 Ken. 708, 74 S. W. 726; *Ex Parte Powell*, 74 S. Car. 193, 54 S. E. 236; *Williams* v. *Nat. Bank of Baltimore*, 72 Md. 441; *Ellis* v. *Conrad Seipp Brewing Co.*, 107 Ill. App. 139, aff'd 207 Ill. 291; *Jones on Collateral Securities* (3rd Ed.), Sec. 540).

The creditors here are the bondholders, the Debtor was the obligor on the bonds and The Prudence Company, Inc., the guarantor (R. 330, 351). All of the cash and securities in the Trust Funds were security for their promises to pay, not some of the bonds, but all of the bonds (R. 310-312, 320, 321). Upon payment of some of the bonds, the Debtor's right to a *pro tanto* release of collateral was not absolute; it was governed by Section 6 of Article I of the

Trust Agreement. And, as the Courts below have held, the releases for which petitioner has been surcharged were expressly prohibited by Section 6, because mortgage collateral in the Trust Funds was in default in the payment of principal (R. 524-525, 632-640). Thus, the present bondholders have been deprived of a substantial part of their security in violation of the Trust Agreements; it is no answer to them to say that other bondholders were paid in full (R. 647-648).*

The petitioner suggests here, as it suggested below, that the losses sustained by the Trust Funds are in no way connected with its acts in releasing collateral, but are the result of the real estate depression. Several cases are cited, but the principal case relied upon is *Matter of Adriance*, 145 Misc. 345. That case is cited by petitioner as the leading authority in New York for the proposition that a trustee cannot be surcharged without a showing of a causal connection between the breach of trust and a loss to the trust fund. No such doctrine prevails in New York. The *Adriance* case theory of "proximate cause" as applied to trustees is contrary to earlier and later decisions of, and has never been adopted by, the appellate courts in New York; it has been criticized as unsound (19 Va. L. Rev. 630, 634-635; 32 Col. L. Rev. 1446). In *Matter of Bearns*, 251 App. Div. 222, aff'd 276 N. Y. 590, involving a trustee's failure to give the notice required by Section 188(7) of the Banking Law, "the Court of Appeals"—as stated in *Matter of Ryan*, 181 Misc. 566, 580 (aff'd 264 App. Div. 704, 291 N. Y. 376)—"received many briefs *amicus curiae* and rejected vigorously urged views which sought refusal of

* The record indicates that the cancelled bonds could have been paid by the Guarantor of the bonds, even if the petitioner had complied with the Trust Agreements and refused to permit the releases. During the period of the unauthorized releases and after the date of the last release, the petitioner obtained full payment of an unsecured loan of $2,000,000, it had made to the Guarantor on July 30, 1931 (Objectors' Ex. 14, 5 R. 151, 427).

surcharge unless causal connection was shown between the damage and the lack of notice".*

The rule is well established in New York that if a trustee appropriates trust property to a use not authorized by the trust instrument, such an act is regarded as a devastavit and the funds are at once recoverable; it is unnecessary to show any causal connection between a loss to the trust fund and the unauthorized act. In cases involving trustees who have disbursed trust funds for unauthorized investments, the New York courts uniformly require the trustee to restore the amount invested to the trust fund, and, upon making such restoration, the trustee is entitled to receive, or be subrogated to, the unauthorized investment; it is unnecessary to prove that the investment has caused or will cause a loss to the trust fund (*Matter of Pelton*, 264 App. Div. 176; *King* v. *Talbot*, 40 N. Y. 76; *Villard* v. *Villard*, 219 N. Y. 482; *Steele* v. *Leopold*, 135 App. Div. 247, mod'fd 201 N. Y. 518; *Matter of Poillon*, 165 Misc. 376; *Matter of Haydock*, 158 Misc. 404; see also, Scott on Trusts, Sec. 179.4, p. 950; Sec. 205.1, p. 1101).

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* In the Appellate Division and the Court of Appeals, counsel for the trustee in the *Bearns* case cited the *Adriance* case; *Irving Trust Co.* v. *Natica*, 157 Misc. 32; *Chapter House Circle* v. *Hartford Nat. Bk. & Trust Co.*, 121 Conn. 558, 186 Atl. 543; *Matter of Darlington*, 245 Pa. 212, 91 Atl. 486; each of which cases is cited by the petitioner here.

Many decisions in New York have likewise surcharged trustees without a showing that the failure to give the notice required by the Banking Law was the proximate cause of the loss (*Matter of Roche*, 245 App. Div. 192; *Matter of Westchester Trust Co.*, 249 App. Div. 751, aff'd 274 N. Y. 495; *Matter of Heermance*, 254 App. Div. 685, aff'd *sub. nom.*, *Matter of Prime*, 278 N. Y. 601; *Matter of Peene*, 155 Misc. 155; *Matter of Jones*, 155 Misc. 315; *Matter of Schmidt*, 163 Misc. 156; *Matter of Dimond*, 163 Misc. 611).

Another instance of the rejection by the Appellate Division of the *Adriance* case theory of "proximate cause" as applied to trustees is *Matter of Olney*, 255 App. Div. 195, in which the *Adriance* case was relied upon by the trustee in its brief. In that case a trustee, authorized to invest in mortgage certificates issued with an outside trustee, was surcharged for investing in a mortgage certificate issued without such a trustee, although it did not in any way appear that the loss on the investment was attributable to such factor.

At all events, the cases relied upon by the petitioner have no application here. The Courts below have found and held that petitioner released from the Trust Funds a $115,600 mortgage and $1,085,664.99 cash in violation of the express provisions of the Trust Agreements and without receiving anything in return. The established doctrine of the unauthorized investment cases, cited *supra*, is, therefore, clearly applicable to a case, such as this, where the Trustee did not receive any cash or securities in exchange or in substitution for the Trust Fund cash and securities it wrongfully released or disbursed. The direct and proximate cause of the loss to the Trust Funds is obvious. And in respect of the surcharge for an additional $12,500, the petitioner, by the decree below, has been subrogated to the $12,500 mortgage it wrongfully accepted into the Ninth Series Trust Fund in lieu of $12,500 cash it should have received (9 R. 16).

POINT II

The Circuit Court of Appeals has applied and correctly interpreted the New York law in holding that upon an accounting the liability of a trustee who has wrongfully depleted or disbursed a trust fund is to restore and replenish the fund.

This is an established principle of the law of New York and of trust law generally. The right to enforce this liability of a trustee is a derivative one and in the case of a corporate bond issue secured by a trust fund, the liability can be enforced on behalf of all bondholders irrespective of when they acquired their bonds.

Each of the Trust Agreements here involved created an express trust (*Manufacturers Trust Co.* v. *Kelby*, *supra*). Each is designated as a "Trust Agreement", the Fund as a "Trust Fund", and petitioner as "Trustee" (R. 310-311). The agreement is peppered throughout with

fiduciary verbiage (R. 310-348). The trust was created by expression and intentional act of the parties. The Trustee is designated, the beneficiaries are designated, the Trust Fund is sufficiently identified to enable title to pass to the Trustee, and the Fund was actually assigned and delivered to the Trustee (R. 310-315, 324-326). All of the requirements of an express trust have been met (*Hammerstein* v. *Equitable Trust Co.*, 156 App. Div. 644; *Brown* v. *Spohr*, 180 N. Y. 201; Pomeroy's Equity Jurisprudence (4th Ed.), Vol. 1, Sec. 152; Perry on Trusts (7th Ed.), Vol. 1, Sec. 24).

Petitioner's contention, in respect of the second question it presents, is that a trustee holding a trust fund to secure the payment of corporate trust bonds is not, under the law of New York, liable on an accounting to restore to the fund cash and the value of any other trust property wrongfully diverted or disbursed from the fund by the trustee in violation of the express provisions of the trust instrument. It is petitioner's position that in such a case the trustee is liable only to those persons who owned a bond or bonds on the date or dates of the trustee's wrongs; that neither those bondholders nor a successor trustee has any right to maintain a true class suit—one which is both representative and derivative—against the recreant trustee for the benefit of the trust fund; that the only remedy available to any such bondholder is to sue the trustee in an individual action at law for such an amount of damages as the individual bondholder could establish he personally suffered; and that any sum recovered in such an action would not go back into the trust fund, but would belong solely to the bondholder bringing the action.

As we shall now show, this contention of petitioner has been rejected, not only in the instant case, but also in three prior decisions of the Circuit Court of Appeals for the Second Circuit in this same proceeding. And, as we shall also show, this Court has twice denied certiorari to review the contention petitioner again makes here.

The cumulative effect of these four decisions is that all six Judges now sitting in the Circuit Court of Appeals for the Second Circuit, as well as one former Judge of the same Court (Judge Patterson), are unanimously of the opinion that petitioner's view of the New York law is unsound. This unanimity of opinion by the Second Circuit Judges on a question of New York law is a self-evident manifestation of the improbability of the instant case being in conflict with applicable state law. Indeed, the denial of certiorari to review two of the prior decisions on the question, emphasizes the soundness of the rule of this Court that ordinarily "we accept and therefore do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate federal appellate courts" (*Huddleston* v. *R. H. Dwyer, et al.*, —— U. S. ——, 88 L. Ed. 933, 936).

A moment's reflection upon the position taken by petitioner will compel the conclusion that, if upheld, it would, as Judge Learned Hand said, work "the most perfect injustice" (*Manufacturers Trust Co.* v. *Kelby, supra*, at p. 653). If any such principle were adopted the long established power and jurisdiction of courts of equity to protect, preserve and enforce trusts would cease to exist. Such a rule would place in the hands of a trustee a power to destroy and terminate a trust and frustrate the purpose for which it was created. He could part with the trust fund, or a part thereof, and the bondholders or beneficiaries would be powerless to compel him to account and return to the Fund the wrongfully diverted trust property or its equivalent so that it might continue to be held upon the trusts specified.

In its prior opinion in this proceeding, reported as *Manufacturers Trust Co.* v. *Kelby, supra*, the Circuit Court of Appeals, after a careful analysis of the cases now relied upon by petitioner, except two to which we will refer later, stated that the New York decisions "countenance no such unhappy result". (125 F. 2d 654).

On the petition of Manufacturers Trust Company to review that decision, this Court denied certiorari (319 U. S. 767). And as the Circuit Court of Appeals noted in its next decision in this proceeding, reported as *Brooklyn Trust Co.* v. *Kelby, supra,* petitioner in the instant case paid a "proportionate part of the fee of the counsel who filed the certiorari petition" in the *Manufacturers Trust Co.* case (134 F. 2d 110).*

On the first of the three prior appeals in this proceeding, the Circuit Court of Appeals held that the liability of the Corporate Trustees of the Debtor's bond issues for any diversion or waste of the Trust Funds or *res* is to "restore the waste of assets" or to "restore the *res*" and that the recoveries on the objections "will in any event be part of the security" (*Central Hanover B. & T. Co.* v. *President and Directors of the Manhattan Co., supra,* at pp. 131-132).

In *Manufacturers Trust Co.* v. *Kelby, supra,* the Circuit Court of Appeals again held it to be immaterial that the Trustee did not personally profit by the wrongful diversions of the trust *res,* or that some bondholders who owned their bonds at the time of the acts objected to have since transferred their bonds. The Court again held that such liability can be enforced on behalf of all bondholders.

A few days after certiorari was denied to review the latter decision, petitioner and Brooklyn Trust Company again raised the same question by instituting a fictitious action in the New York State Supreme Court, in which petitioner was defendant and Brooklyn Trust Company plaintiff. The bankruptcy court, as previously noted, enjoined that suit and its order was upheld in *Brooklyn Trust Co.* v. *Kelby, supra;* the Circuit Court of Appeals stating that "It is fairly obvious, then, what Brooklyn and Manhattan (petitioner) wanted to accomplish in that suit and why: * * * Manhattan, as defendant, wanted to lose

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* Brooklyn Trust Company was Trustee of one and Manufacturers Trust Company Trustee of two, of the Debtor's eighteen Series of bonds.

the case on the issue as to whether a former owner of a bond, as distinguished from a present holder, could recover." (134 F. 2d 118).

In its opinion in the *Brooklyn Trust Co.* case the Circuit Court of Appeals again rejected the contention which petitioner again makes here. The Court restated "somewhat more amply" the reasons for its two earlier decisions and pointed out that by the objections to the accounts the Objectors (respondents here) seek restoration of the trust *res* "derivatively and for the benefit of the respective trust funds" (134 F. 2d 109, 110).

Once again this Court denied certiorari (319 U. S. 767). And once again in the instant case, the Circuit Court of Appeals, after again making a careful analysis of the New York decisions upon which petitioner relies (R. 643-645), has held that such decisions are inapplicable to a proceeding, such as this, "brought against the trustee for the restoration of the trust fund." (R. 644).

These decisions of the Circuit Court of Appeals are in accordance with basic principles of the law of trusts long established in New York and elsewhere. As long ago as *May* v. *Le Claire*, 11 Wall. 217, this Court, in ordering an accounting, held that if restoration of the specific trust property is impossible, the court may compel the trustee to "account for its present value" (11 Wall. 217, 237). That principle was applied in *Isenberg* v. *Trent Trust Co.*, 31 F. 2d 553 (on rehearing of same case, 26 F. 2d 609), cert. den., 279 U. S. 869. There the trustee had wrongfully failed to reduce to possession certain stock forming part of the trust estate. On an accounting by the trustee it was held that the beneficiaries were entitled to restoration of the lost trust property in kind or to its value, the Court stating that this rule is "abundantly supported by authority" (31 F. 2d 553, 555).

This principle also was applied to a trust securing a corporate bond issue in *Cherry* v. *Howell*, 66 F. 2d 713, a derivative suit in equity brought by two Class D bondholders of the Southern Guaranty Loan Company on behalf of

themselves and all other Class D bondholders against directors of that company. It was alleged that the loan company diverted various funds held by it as trustee for the bondholders and that the directors sued were liable because they committed and caused the trustee to commit the alleged wrongful diversions of the trust property. The Court held that "the liability which resulted was to replenish the fund so that it might continue to be held upon the trust specified" and that "any recovery will be for the benefit of the trust estate as such and not for the benefit of the plaintiff personally." (66 F. 2d 716). In that case the Circuit Court of Appeals for the Second Circuit relied upon, among other cases, the case of *Western R. R. Co.* v. *Nolan*, 48 N. Y. 513.

The law as enunciated in the foregoing cases has long been the settled law of the State of New York (*O'Beirne* v. *Bullis*, 80 Hun 570, aff'd *sub nom.*, *O'Beirne* v. *Allegheny & Kinzua R. R. Co.*, 151 N. Y. 372; same case on second trial as to certain defendants, *O'Beirne* v. *Bullis*, 2 App. Div. 545, aff'd 158 N. Y. 466, rearg. den., 158 N. Y. 719; *Harvey* v. *McDonnell*, 113 N. Y. 526; *Harrison* v. *Union Trust Co.*, 80 Hun 463, aff'd 144 N. Y. 326; *Ettlinger* v. *P. R. Co., et al.*, 142 N. Y. 189; *Weetjen* v. *St. Paul & Pac. R. R. Co.*, 4 Hun (N. Y.) 529; *Weetjen* v. *Vibbard*, 5 Hun (N. Y.) 265; *Atlantic Trust Co.* v. *Crystal Water Co.*, 72 App. Div. 539; *Robinson* v. *Adams*, 81 App. Div. 20, aff'd 179 N. Y. 558; *Smith* v. *Stevenson Brewing Co.*, 117 App. Div. 690; *Agne* v. *Schwab*, 123 App. Div. 746; *Hart* v. *Goadby*, 138 App. Div. 160; *Herrington* v. *Laimbeer*, 252 App. Div. 66). It also has been consistently applied in other Federal Court decisions (*Backer* v. *Levy*, 82 F. 2d 270; *In re Dolcater*, 106 F. 2d 30).

The right of a *cestui* to compel the replenishment of a trust fund is, as the Courts below have held, essentially a derivative one, because it is the trustee who is vested with legal title to the fund. Any beneficiary of an express trust may call the trustee to account (*Hart* v. *Equitable Life Assurance Soc.*, 172 App. Div. 659). Indeed, the *cestui's* right

to an accounting does not in any way affect his right also to sue a fraudulent grantee or vendee (*Agne* v. *Schwab, supra; Noll* v. *Smith*, 250 App. Div. 453).

The well settled principle of derivative suits by stockholders in the right of the corporation, applies equally as strongly to suits by bondholders, in the right of the trustee, to compel restoration of a trust fund (*Brooklyn Trust Co.* v. *Kelby, supra; Ettlinger* v. *P. R. Co., et al.*, 142 N. Y. 189; *Boesenberg* v. *Chicago T. & T. Co.*, 128 F. 2d 245; *Marion Mortgage Co.* v. *Edmunds*, 64 F. 2d 248; *Citizens Banking Co.* v. *Monticello State Bank*, 143 F. 2d 261; *Redmond* v. *Commerce Trust Co.*, 144 F. 2d 140, cert. den., 89 L. Ed. 29; *Miller* v. *National City Bank*, C. C. A. 2, decided March 5, 1945, —— F. 2d ——).

The doctrine of these cases that the recovery goes to restore or replenish a fund, and not to a bondholder or stockholder individually, has frequently been recognized and applied by this Court in determining the amount in controversy in order to support either the question of federal jurisdiction or the right of appeal. In a true class suit or proceeding, as is the instant case, the amount in controversy is the amount sought to be recovered for the benefit of the fund (*Shields* v. *Thomas*, 17 How. 3, 4-5; *The "Connemara"*, 103 U. S. 754, 756; *Davies* v. *Corbin*, 112 U. S. 36, 40; *Handley* v. *Stutz*, 137 U. S. 366; *New Orleans Pac. Ry.* v. *Parker*, 143 U. S. 42, 50-51; *Troy Bank* v. *Whitehead & Co.*, 222 U. S. 39, 40-41; Class Suits and the Federal Rules, 22 Minn. L. Rev. 34).

Suits for the benefit of a class are provided for by the New York Civil Practice Act (Sec. 195) and the Federal Rules of Civil Procedure (Rule 23). And in New York the rules respecting parties authorized to maintain suits in equity for the benefit of a class are the same as those established by the chancery courts (*McKenzie* v. *L'Amoureaux*, 11 Barb. (N. Y.) 516, cited with approval, *Brenner* v. *Title G. & T. Co.*, 276 N. Y. 230; see also *Atkins* v. *Trowbridge*, 162 App. Div. 629; *New York State Railways* v. *Security Trust Co.*, 135 Misc. 456).

The *O'Beirne* cases, *supra,* are direct authority for the proposition that in New York a holder of corporate bonds secured by a trust indenture has a right to maintain a derivative and representative suit on his own behalf and on behalf of all other bondholders to compel the turning over to a mortgage trustee of the value of property which it had been agreed should be covered by the lien of the mortgage as security for bonds issued thereunder. Certain defendants there had agreed that various timber lands would be subjected to the lien of the trust mortgage. Plaintiff had demanded that the trustee bring suit to enforce the agreement, and, on its refusal, commenced the suit on his own behalf and on behalf of all bondholders. Plaintiff's right to maintain the suit was strenuously contested. The New York Court of Appeals sustained his derivative right to sue in such representative capacity to compel the specific performance of the agreement or "to compel the defendant to pay to the trustee, for the security of the bondholders, the value of said lands" (151 N. Y. 372, 377). It appearing that the defendants in question were not the owners of the land which they had agreed should be subjected to the lien of the mortgage, the decree provided for the payment of money to the trustee.*

Eight years had elapsed between the bringing of the suit and the affirmance of the final judgment against Bullis and Barse by the New York Court of Appeals. Still, the decree directed that the money substitute for the property be paid over to the trustee for the *pro rata* benefit of all bondholders. Thus the judgment inured to the benefit of all bondholders irrespective of when they acquired their bonds.

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* The decree provided:

"That the defendants Spencer S. Bullis and Mills W. Barse at once pay to the Central Trust Company of New York the sum of $292,125.00 with interest thereon at the rate of five per cent per annum from the first day of February, 1892, for the *pro rata* benefit of the plaintiff, James R. O'Beirne, and all other holders of the first mortgage bonds of the defendant, The Allegheny and Kinzua Railroad Company." (*Matter of Bullis,* 68 App. Div. 508, 515-516).

In *Zebley* v. *Farmers L. & T. Co.*, 139 N. Y. 461, reversing 63 Hun 541, the Court of Appeals held that the plaintiff, who was the owner of eleven bonds, was entitled to an accounting against a trustee who had improperly transferred property held by it as security for the bonds, even though it appeared from the complaint and arguments of counsel in the case that he had acquired his bonds subsequent to the alleged wrongful transfer of the trust property.* The New York Court of Appeals, in that case, by reversing a decision of the General Term (now Appellate Division), upheld, in principle, the view of the General Term Justice, who, in dissenting from the majority, stated: "We have always regarded it as elementary that a *cestui que trust* had a right to demand of a trustee an accounting as to the administration of his trust; and in this respect there can be no distinction between the trustee of a railroad company and any other trustees" (63 Hun 549, 550).

The rule of the many cases cited above has never been modified or overruled in New York, as we shall see in our subsequent discussion of the cases relied upon by petitioner. The *O'Beirne* cases, *supra*, go much further than is necessary to support the decision below. The property there involved never had actually been in the trust fund; here, the Courts below have found and held that the petitioning Trustee wrongfully disbursed securities and cash constituting part of the Trust Funds in violation of the express provisions of the Trust Agreements and without receiving anything in place of or in substitution therefor.

The New York courts traditionally have given to corporate trust bonds "every practicable facility as the basis of commercial transactions" (*Reynolds* v. *Title G. & T. Co.*, 240 N. Y. 257, 262). It is also well established law, both in New York and in the Federal Courts, that, in equity, the

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* The complaint had alleged:

"That this plaintiff and the holders of said eleven bonds had no notice of * * * said transfer * * * " (Record on Appeal, p. 9, *Zebley* v. *Farmers L. & T. Co.*, *supra*).

security follows the debt (*Vail* v. *Foster,* 4 N. Y. 312; *Chapman* v. *Brooks,* 31 N. Y. 75; *Craig* v. *Parkis,* 40 N. Y. 181; *Central Trust Co. of N. Y.* v. *N. Y. Equipment Co.,* 87 Hun (N .Y.) 421; *Edwards* v. *Bay State Gas Co.,* 184 Fed. 979; *Virginia Ry. & Power Co.* v. *Davis,* 284 Fed. 479, cert. den., 260 U. S. 746; *Colebrooke on Collateral Securities,* Sec. 79; 11 C. J. S., Bonds, Sec. 74). In *Virginia Ry. & Power Co.* v. *Davis, supra,* the Court stated (284 Fed. 479, 481):

> "It makes no difference whether Davis acquired the bonds before or after the diversion. The assignment of the bonds, whenever made, carried with it all the security provided by the mortgage and all the rights, interests, and remedies of the mortgagee. Davis, as assignee, had the right to follow the mortgaged property wherever found, except in the hands of a purchaser for value without notice. 3 Pomeroy's Eq., Sec. 1210; *Chicago, M. & St. P. Ry. Co.* v. *Third Nat. Bank,* 134 U. S. 276, 10 Sup. Ct. 550, 33 L. Ed. 900; *Shields* v. *Ohio,* 95 U. S. 319, 24 L. Ed. 357; *Fosdick* v. *Schall,* 99 U. S. 235, 25 L. Ed. 339; *Linder* v. *Hartwell R. Co.,* (C. C.), 73 Fed. 320; *Zinn* v. *Denver Livestock Com. Co.,* 68 Colo. 274, 187 Pac. 1033."

Not only is it an established principle of equity that the security follows the debt; in this case the principle is written into the Trust Agreement. It provides in unmistakable language that the Trust Fund is for the equal and *pro rata* benefit and advantage of all bonds, irrespective of when the securities and cash "constituting" the Fund were deposited with the Trustee and irrespective of the actual date of the issuance and negotiation of the bonds. (R. 312, 320, 321, see *supra* pp. 10-11).

Over seventy-five years ago, in *Galveston Railroad* v. *Cowdrey,* 11 Wall. 459, 477, this Court stated: "A contrary doctrine * * * would seriously impair the negotiability and value of such securities (railroad bonds). Must a person purchasing bonds in Wall Street or Walnut Street, first send to Illinois, California or Texas, to see whether the meeting of the directors which authorized the mortgage given to secure the bonds was held in a proper place?"

The reasoning of that statement by this Court applies with even greater force to petitioner's contention.* If the right to compel a trustee to restore a wrongfully depleted trust fund to its proper level did not follow the security and run with the bond no one could rely upon a trust agreement or a trustee and no one would be safe in selling or purchasing a collateral trust bond until he first went to the trustee, accompanied by a lawyer and an accountant, and made an investigation of all acts of the trustee with respect to the trust fund from the inception of the trust. If petitioner's contention were correct and a person purchased a Prudence or other corporate trust bond today, and yesterday the trustee dissipated the entire trust fund, the new bondholder would have no security whatever for his bond and no right to complain of the trustee's wrong. As Judge Learned Hand said in *Manufacturers Trust Co.* v. *Kelby, supra,* at p. 654:

> "* * * For the truth is—whatever may be said as to other breaches—that whatever remedy the law gives for an actual depletion of the *res* as against a mere injury to it—is a substitute for the very subject matter of the transfer itself; and that, unless it passes to the assignee, the transfer has been frustrated, as would very plainly appear if the trustee had parted with the whole *res.* That we should not so construe the intent of the parties as to foil their venture, is a cardinal principle of all interpretation."

The authorities discussed above dispose of petitioner's argument that in New York a trustee who has wrongfully parted with trust property cannot be compelled to restore the trust fund. They also dispose of its argument that a holder of a corporate trust bond has no interest in any such recovery if he did not own his bond at the time of the trustee's wrongful depletion of the trust fund.

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* Prudence bonds are held by a large number of persons residing in New York State and elsewhere throughout the United States and in foreign countries and a substantial number of the bonds are held by the savings bank type of investor with limited means and limited investment experience (R. 544).

The decision below and the prior decisions of the same Court in this proceeding are clearly in accordance with the law of New York governing the liability of a trustee of an express trust, whether it be a trust securing an issue of corporate trust bonds or for some other purpose. Indeed, both in *Elkind* v. *The Chase Bank,* 259 App. Div. 661 (aff'd no op., 284 N. Y. 726), and in *Smith* v. *Continental Bank,* 292 N. Y. 275, two of the cases principally relied upon by the petitioner, the New York Courts clearly recognized the distinction between the actions there involved and a representative and derivative suit by a bondholder to compel restoration of a trust *res.* In the *Elkind* case, the Appellate Division stated that the suit before it was unlike "a suit to recover property that was subject to the lien of the mortgage" (259 App. Div. 665). And in the *Smith* case, the Court of Appeals clearly indicated that the action before it was "personal and not representative" and pertained to "a breach of fiduciary duty not involving a surrender or release of the mortgaged property" (292 N. Y. 278, 279). The action was at law and the plaintiff was seeking money damages for himself individually; it was not a suit in equity to compel a trustee to account and restore trust property for the benefit of a trust fund and all bondholders as a class. The *Smith* case was carefully considered by the Circuit Court of Appeals and held to be inapplicable (R. 644-645).

The cases relied upon by petitioner, in addition to the *Elkind* and *Smith* cases, are *Mittlemann* v. *President, etc. of Manhattan Co.,* 248 App. Div. 79, aff'd no op., 272 N. Y. 632; *Weil* v. *President, etc. of Manhattan Co.,* 275 N. Y. 238; *Hendry* v. *Title Guarantee & Trust Co.,* 255 App. Div. 479, aff'd in part no op., 280 N. Y. 740; and *Emmerich* v. *Central Hanover B. & T. Co.,* 34 N. Y. S. 2d 166, aff'd no op., 265 App. Div. 808, 291 N. Y. 570. Each of these cases, except the *Emmerich* and *Smith* cases, which had not as yet been decided, was carefully considered and reviewed by the Circuit Court of Appeals and held inapplicable in *Manufac-*

turers Trust Co. v. *Kelby, supra.* All, except the *Smith* case, were cited and relied upon by Manufacturers Trust Company in petitioning for certiorari to review that decision; the opinion of the Special Term Judge in the *Emmerich* case being annexed as an appendix to the petition for certiorari. The *Emmerich* case was considered by the Circuit Court of Appeals in deciding *Brooklyn Trust Co.* v. *Kelby, supra* (R. 644), and was cited and relied upon by Brooklyn Trust Company in petitioning for certiorari to review that decision. And in the decision petitioner now seeks to review, the Circuit Court of Appeals has reexamined the cases upon which petitioner relies, including the *Hendry, Emmerich* and *Smith* cases, and once again has held that they have no application to a suit to compel restoration of a trust *res* (R. 643-645).

The *Weil* and *Mittlemann* cases, *supra,* involved certificate issues of New York Title & Mortgage Company. They were actions at law by "Schackno Act" * Trustees, having limited statutory powers. The object of the action in each case was to recover damages for alleged torts of the defendant, with whom the Title Company had deposited various bonds and mortgages, against which mortgage certificates representing undivided shares therein had been assigned to certificate holders. The defendant bank was a mere depositary and agent for the certificate holders. It was not a trustee and did not have and never had legal title to the deposited bonds and mortgages (*Matter of People* (Title & Mtg. G. Co. of Buffalo), 264 N. Y. 69, affirming 149 Misc. 643; *Matter of People* (New York Title & Mtg. Co.), 264 N. Y. 475; *Title G. & T. Co.* v. *Mortgage Comm'n,* 273 N. Y. 415; *Matter of New York Title & Mtg. Co.,* 241 App. Div. 351; *Matter of Lawyers Westchester Mtg. & T. Co.,* 247 App. Div. 895; *Wiltsie on Mortgage Foreclosures* (1939), Vol. 1, p. 492).

* N. Y. Unconsolidated Laws, Secs. 1796 *et seq.,* L. 1933, c. 745, as amended.

The petitioner is mistaken in asserting that the New York Courts "make no distinction between depositary and trustee cases". In the *Weil* case, the attorneys for the defendant placed considerable reliance upon the fact that, in cases involving mortgage certificates, title to the deposited bonds and mortgages had not been assigned or transferred to the defendant. A considerable portion of their brief was devoted to showing that the defendant was a mere depositary and not a trustee, that its rights and liabilities as depositary were not to be governed by the rules applicable to trustees of express trusts, and that since the defendant bank was not a trustee but merely a depositary, custodian or bailee, no action for an accounting would lie against it (*Weil* case, *supra*, Record on Appeal, defendant-respondent's brief, pp. 74-78). The Court of Appeals agreed and so held, stating (275 N. Y. 238, 243):

> "In the action at bar the defendant was not the owner of the mortgages deposited with it. Neither was it a trustee of the mortgages deposited." *

Petitioner's contention that the Circuit Court of Appeals misinterpreted the *Weil* and *Mittlemann* cases is further re-

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* It is only after reorganization in proceedings under the "Schackno Act", *supra*, or the "Mortgage Commission Act" (New York Unconsolidated Laws, Secs. 1751 *et seq.*, L. 1935, c. 19, as amended), that the bonds and mortgages in which certificate holders had undivided interests are held by trustees. Upon reorganization, each certificate issue is operated under a separate standard form declaration of trust. The certificates are held by over 200,000 investors, the corpus of these trusts exceeds $700,000,000 and their administration in and about the City of New York is lodged in the hands of over 250 trustees appointed by Justices of the New York Supreme Court. These trustees must account to the court annually and, upon objections to their accounts, they have, on occasion, been surcharged and ordered to reimburse the estate with the amount of the surcharge. The mortgage certificates are dealt in on the open market and change hands daily and it is quite obvious that many persons who are certificate holders at the time of the trustee's annual accounting were not certificate holders at the time of a wrongful disbursement or other act

(Footnote continued on next page)

futed by *Matter of People* (*Lawyers West. Mtg. & T. Co.*), 288 N. Y. 40, 47, in which the New York Court of Appeals, in explaining its decisions in those cases, pointed out, among other things, that those actions "were brought to enforce tort liabilities".

The *Hendry* case, *supra*, related to a mortgage certificate issue of Title Guarantee and Trust Company. The certificates there involved also created a legal relationship distinctly different from the legal relationship created by the bonds, Trust Agreements and Trust Funds here involved. A mortgage certificate of Title Guarantee and Trust Company is not a secured promise to pay; it is an assignment of an undivided share in a mortgage. Holders of such certificates are merely "tenants in common, each entitled to an aliquot share of the mortgage referred to in the certificate" (*Title G. & T. Co.* v. *Mortgage Comm'n*, *supra*, at p. 422). The relationship between the Title Company and the certificate holders was not that of trustee and *cestui que trust* (see cases cited supra, p. 36). Legal title to the underlying mortgage, although originally acquired and held by the Title Company, was, by the issuance of mortgage certificates, assigned in aliquot shares to the certificate holders, who then became tenants in common of the legal title to the mortgage. The Title Company, as pointed out by the Circuit Court of Appeals, merely held "the mortgaged documents as agent and depositary for the certificate holder; for this distinction see *Strebler* v. *Title Guaranty & Trust Co.*, 277 N. Y. 730 (Mem. Op.); *Fischer* v. *Title*

(Footnote continued from preceding page)

of a trustee which subjects him to a surcharge. And it is also manifest that a person acquiring a certificate the day before a surcharge is paid into the trust estate obtains the benefit thereof. No one has yet suggested in the New York courts that these trustees are liable only to certificate holders who owned their certificates on the day a trustee made an improper disbursement or otherwise depleted the trust estate. Quite the contrary, these trustees are treated like any other trustee of an express trust (see Article entitled "The Administration of Guaranteed Mortgage Trusts", and cases cited therein, N. Y. Law Journal, January 6, 1942, p. 58, January 7, 1942, p. 76, and January 8, 1942, p. 96).

Guaranty & Trust Co., 176 Misc. 166, rev'd on other grounds, 262 App. Div. 293, aff'd 287 N. Y. 275." (R. 644).

Moreover, mortgage certificates of Title Guarantee & Trust Company, unlike Prudence bonds, did not pass from hand to hand by delivery or assignment (R. 326). The mortgage certificates in the *Hendry* case, in the usual form of Title Guarantee and Trust Company certificates, specifically provided (see *Title G. & T. Co.* v. *Mortgage Comm'n*, *supra*, at p. 420):

> "This certificate is not negotiable. The only way that the interest of the purchaser can be transferred is by the surrender of this certificate to the Company duly assigned and the issuing of another certificate to the transferee." *

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* In the *Hendry* case, the attorneys for the defendant Title Company argued with respect to the two certificate holders who had acquired their certificates after the time of the defendant's wrong (Record on Appeal, 255 App. Div. 497; Defendant-Appellant's Brief, pp. 13-14):

> "It is obvious that when their certificates were purchased the purchasers took a participation in the mortgage as it existed at that time. Their rights were in no sense derivative. At that time a portion of the original mortgaged premises had already been released and the mortgage had been extended to cover the remaining premises. These two plaintiffs, or their predecessors then, purchased their certificates in a mortgage on specifically identified property and defendant committed no act to injure their security after their purchase.
>
> "To hold to the contrary would mean that when defendant sold the two certificates referred to, it assigned at the same time a cause of action against itself to recover 7/10ths of the purchase price. Such a result, of course, is absurd. It is clear that defendant acquired the participation in the mortgage which it sold to these two plaintiffs from the former certificate holders who had turned in their certificates upon the extension of the mortgage on January 8, 1930 (see fol. 170). While the former certificate holders may have held a cause of action against defendant for the acts stated in the complaint, any such cause of action was immediately extinguished, in accordance with the theory of merger, when defendant reacquired their participations in the mortgage."

The decision of the Appellate Division in the *Hendry* case was affirmed without opinion by the Court of Appeals, but the unsuccessful certificate holders had not appealed to that Court (280 N. Y. 740).

Thus, when a certificate was surrendered to the Title Company and a new certificate issued, a new relationship of assignor and assignee and of principal and agent was created; the Title Company being the assignor or agent and the new certificate holder the assignee or principal. Each certificate holder, having acquired his certificate by assignment direct from the Title Company, would have no cause of action against his agent for a wrong which his agent committed to some other principal.

In *Matter of 24-52 44th Street, Long Island City*, 176 Misc. 249, the Court held that upon an assignment of a mortgage participation certificate of the Greater New York Suffolk Title & Guarantee Company, all rights which the assignor had in the security and collateral passed to the assignee in the absence of an express reservation by the assignor, and stated that "this conclusion seems to find ample support in cases relating generally to the assignment of a contractual right" (p. 254). The Court, in that case, pointed out (p. 253), that the decision in the *Hendry* case, *supra,* was reached upon the authority of other cases which were "decided on the theory that under the facts and circumstances involved *it was not intended by the parties to transfer the rights of action for the previous breach.*" (Italics the Court's). And in *In re Prudence Co. Inc.*, 55 F. Supp. 464, 466, the Court noted the fact that the mortgage certificates involved in *Matter of 24-52 44th Street*, "were never surrendered" and said "hence upon a sale of such certificates they carried all the rights thereunder."

With these principles and legal distinctions in mind, it becomes clear that the holding in the *Hendry* case, to the effect that a certificate holder had no cause of action against the Title Company for a breach of a fiduciary obligation unless he held his certificate at the time of the act complained of, is not here applicable. As this Court stated in *McCandless* v. *Furland*, 296 U. S. 140, 163: "Confusion of thought is inevitable unless the position of the wrongdoers as trustees is steadily kept in mind."

The *Elkind* case, *supra,* clearly indicates the difference in New York between the rules applicable to suits for breaches of fiduciary obligation giving rise to a personal tort action at law for damages and a claim on behalf of beneficiaries of a trust to recover on behalf of the trust fund for the wrongful act of a trustee resulting in a depletion of the fund. The plaintiffs in the *Elkind* case, unlike respondents here, were seeking to compel the defendant trustee to account for money and property which had never been, and never was intended to be, part of the trust fund. The Circuit Court of Appeals, in *Manufacturers Trust Co.* v. *Kelby, supra,* at pp. 652-653, clearly distinguished the *Elkind* case from the situation here involved.

Emmerich v. *Central Hanover B. & T. Co., supra,* like *Smith* v. *Continental Bank, supra,* was an action at law in which plaintiff was seeking money damages for himself and not restoration of a trust fund on behalf of all bondholders. In the *Smith* case, the New York Court of Appeals specifically referred to its holding in the *Emmerich* case as pertaining to "a breach of fiduciary duty not involving a surrender or release of the mortgaged property" (292 N. Y. 279). The complaint in the *Emmerich* case alleged three causes of action. The act complained of in the first cause of action in no way involved a surrender or depletion of the trust *res.* The second and third causes of action also sought damages on behalf of plaintiff individually and not restoration of the trust *res.* And even if it be argued that the acts complained of in these two causes of action involved a depletion of the *res*, the fact is, as noted by the State Reporter, that "Plaintiff conceded in the Court of Appeals that the second and third causes of action stand or fall with the first." (291 N. Y. 571). Moreover, in their brief in the Court of Appeals, counsel for the plaintiff in the *Emmerich* case affirmatively stated "This is neither a derivative nor representative action." (*Record on Appeal*, 291 N. Y. 570, plaintiff-appellant's brief, p. 2). And in their brief in the Court of Appeals, counsel for the defendant Bank, in

distinguishing the situation in the *Emmerich* case from *Manufacturers Trust Co.* v. *Kelby, supra,* stated "The rationale of the rule enunciated in the *Elkind* and kindred cases, *supra,* is that a manifest distinction exists between an action like the present, which is brought only for the recovery of damages for alleged breach of fiduciary duty, and one which seeks the recovery of property that was wrongfully surrendered and released from the lien of a mortgage. * * * The *Manufacturers Trust Co.* case is plainly in no way parallel to the instant case or in any way inconsistent with the *Elkind* case, *supra*" (*Emmerich* case, Record on Appeal, 291 N. Y. 570, 571, defendant-respondent's brief, pp. 30, 33).

None of the cases relied upon by petitioner in any way detract from the force of the decisions of the New York Court of Appeals in the *O'Beirne* and other cases to which we have referred, *supra,* and there is not the slightest conflict between the decisions of the Circuit Court of Appeals and the law of New York governing the liability of a trustee of an express trust in the circumstances here (see also, *Clarke* v. *Chase Bank,* 137 F. 2d 797; *Elias* v. *Clarke,* 143 F. 2d 640, cert. den., 89 L. Ed. 93). As the Circuit Court of Appeals stated (R. 643-644):

> "The Bank contends that the New York decisions restrict the right of suit to those bondholders who held their bonds at the time that the wrong was committed by the trustee. This court, in another chapter of this litigation, has heretofore held that, under the New York decisions, this rule is inapplicable to such proceedings as this, brought against the trustee for the restoration of the trust fund. *Manufacturers Trust Company* v. *Kelby,* 125 F. (2d) 650. It is now urged that *Smith* v. *Continental Bank,* 292 N. Y. 275, recently decided, shows that this distinction was erroneous. But in the *Smith* case, the trustee did not surrender any portion of the *res.*"

The contention made by petitioner under its second question that the Circuit Court of Appeals failed to follow the law of New York is, therefore, wholly untenable.

POINT III

There is no necessity for encouraging or directing litigation in the State Court on the issues here involved.

We have shown, *supra*, that, under the decisions in New York, there is no merit to the contentions petitioner advances under its first and second questions. The decision of the Court below is not in conflict with applicable local decisions. There is, therefore, no necessity for this Court to encourage or direct litigation in the state court to obtain answers to the questions. The mere fact that questions of state law may be involved in a case in the federal court, and more particularly the bankruptcy side of the court, does not require the federal court to stay its hand and send the matter to the state court for adjudication (*Alexander* v. *Hillman*, 296 U. S. 222; *Meredith* v. *Winter Haven*, 320 U. S. 228; Cf. *Burford* v. *Sun Oil Co.*, 319 U. S. 315). There is, we submit, no room here for the application of the doctrine of cases such as *Railroad Comm'n* v. *Pullman Co.*, 312 U. S. 496, and *Chicago* v. *Fieldcrest Dairies*, 316 U. S. 168 (see *Brooklyn Trust Co.* v. *Kelby*, *supra*, at p. 116).

Nor is this a case like *Fidelity Trust Co.* v. *Field*, 311 U. S. 169; the Court below has not taken the view that the state decisions relied upon by the petitioner do not truly express the state law. And the issues in the instant case are far removed from the situation involved in *Spector Motor Service* v. *McLaughlin*, ... U. S. ...., 89 L. Ed. 105. The state law here involved, is, as we have shown, well established and the Courts below have decided the pertinent questions in accordance with the state decisions.

"No litigation is pending in the state courts in which the questions here presented could be decided." (*Meredith* v. *Winter Haven*, *supra*). This litigation has been pending in the bankruptcy court since 1938 (R. 18, 22), or almost five years longer than the federal litigation involved in *Mere-*

dith v. *Winter Haven,* which this Court refused to remit to a state court. To now send these cases to the state court for retrial would, we submit, introduce unnecessarily "additional elements of uncertainty and would involve unnecessary delay, work and expense" (*Alexander* v. *Hillman, supra,* at p. 243). It would, as this Court indicated in the *Meredith* case, penalize the bondholders, for whom petitioner is Trustee, "for resorting to a jurisdiction which they were entitled to invoke"; indeed a jurisdiction, which, as the Circuit Court of Appeals noted, petitioner itself had been "eager" to invoke when it petitioned the bankruptcy court for a judicial settlement of its accounts as Trustee (see *Brooklyn Trust Co.* v. *Kelby, supra,* at pp. 108, 119-120).

CONCLUSION

The petition for writs of certiorari should be denied.

Respectfully submitted,

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Charles M. McCarty,
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Joseph Nemerov,
Counsel for Hilda S. Reese, Leopold Helfant, Sarah Helfant and Samuel Plasser,

Respondents.

March 20, 1945.

(3)

IN THE

Supreme Court of the United States

October Term.

Numbers 1001, 1002.

PRESIDENT AND DIRECTORS OF THE MANHATTAN COMPANY,

Petitioner,

v.

CHARLES H. KELBY, CLIFFORD S. KELSEY, Trustee of the Debtor, PRUDENCE BONDS CORPORATION (New Corporation), GEORGE E. EDDY, and HILDA S. REESE,

Respondents.

BRIEF FOR RESPONDENT GEORGE E. EDDY IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

Samuel Silbiger,
Counsel for Respondent,
George E. Eddy.

Mark Service, BArclay 7-2180

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IN THE

Supreme Court of the United States

October Term.

Numbers 1001, 1002.

President and Directors of The Manhattan Company,
Petitioner.

v.

Charles H. Kelby, Clifford S. Kelsey, Trustee of the Debtor, Prudence Bonds Corporation (New Corporation), George E. Eddy, and Hilda S. Reese,
Respondents.

BRIEF FOR RESPONDENT GEORGE E. EDDY IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

Opinion Below.

The opinion of the District Court (R. 617-621)* is reported in 57 Fed. Supp. 839, together with the opinion of the Special Master, at p. 844. The opinion of the Circuit Court of Appeals (R. 632-655) is not yet reported.

*References are to Record in the Fifth Series.

Jurisdiction.

The opinion of the Circuit Court was rendered December 18, 1944 (R. 630) and the supplemental opinion on February 2, 1945 (R. 655). The orders, review of which petitioner seeks were entered February 16, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the judicial code, as amended by the Act of February 13, 1945 (U. S. Code Title 28, Sec. 347).

Questions Presented.

1. Upon an accounting by the Trustee under a trust agreement securing an issue of corporate bonds, made pursuant to an order which removed the trustee from office and substituted another Trust Company as Trustee of the trust fund, is the surcharge of accountant for its acts in violation of the express terms of the trust agreement, in conflict with applicable law of the State of New York?

2. Where the public owners of bonds secured by a trust mortgage were very numerous and totaled 1486 (R. 383), and the successor trustee was absolved from any duty to assert and prosecute claims of the bondholders against the predecessor trustee for a devastavit, can a bondholder, who held and owned his bond at all the times the trustee committed the acts of misfeasance or nonfeasance (R. 549, Finding 40) and still owns his bond, assert and prosecute a representative claim against the Trustee in behalf of all bondholders for a restoration to the trust fund of the sums improperly released and surrendered by the Trustee in violation of the express terms of the trust agreement; and is the assertion of such representative claim against the Trustee for a restoration of the res in conflict with the law in New York State?

Statement.

In addition to the facts set forth in the petition, it is undisputed that there were 1486 bondholders (R. 383) and that respondent GEORGE E. EDDY was a bondholder at all times mentioned in the objections to the Trustee's account, that he duly filed objections to said accounts, (R. 120, 549) and adopted the objections and exceptions that were interposed by the New Corporation and the Trustees of the Debtor (R. 121).

I.

The law of New York State was properly applied by the Court below.

The petitioner contends that as Prudence-Bonds Corporation (New Corporation) and the Trustee of the Debtor were not the holders of bonds and since Hilda S. Reese only acquired her bond in September 1933, after the last improper release of any of the Trust Funds, that the decision below is contrary to controlling New York decisions, under which it claims an action can only be asserted individually by beneficiaries who were such at the times of the alleged breaches of trust. But these parties were not the only objectors to the accounts of petitioner. Respondent George E. Eddy filed objections and he was a bondholder at all the times mentioned in the objections. These objections were filed by him on his own behalf and on behalf of all bondholders and the question of whether the New Corporation, the Trustees of the Debtor and Hilda S. Reese properly could also file objections and participate in the proceedings is purely academic. As there was a bondholder who concededly had the right and did assert objections to the accounts the only practical issue presented herein is whether such

bondholder's rights were limited under New York Law to the assertion and prosecution of a claim for his individual damages.

It is respectfully contended that under New York Law the bondholders had an undoubted right to assert a representative or class claim in behalf of all beneficiaries of the trust and to obtain a decree for a restoration of the sums whereby the trust fund was depleted and the security of all the bondholders impaired.

Where a corporate trustee commits acts of misfeasance or malfeasance resulting in a depletion of the trust fund, prior to the maturity of the bonds secured thereby,

(1) A bondholder could postpone any action for the misconduct of the trustee and await the maturity of his bond—whereupon, if the bond were paid in full—he could have no cause to complain. If at maturity there was a default, it would then become the duty of the trustee to liquidate the security, file its account and apply for a decree for a distribution of the proceeds of the collateral ratably among those entitled to share therein. Such an account would be with a view to a termination of the trust and the distribution of the trust funds to the beneficiaries. Such type of right and remedy of bondholders is not applicable or germane to the facts in this case.

(2) A bondholder, in lieu of waiting until the maturity of his bond, in the event of the trustee's breach of duty, could commence an equitable proceeding for the removal of the trustee, the appointment of a successor trustee and for a decree directing the removed trustee to render its account. Such a proceeding contemplates a continuance of the trust, and the bondholders have only a derivative right to object to the account—such right residing primarily in the successor trustee. This right and remedy pertains to all cases where a trustee is superseded by a successor trustee, whether due to resignation, or otherwise, and applies to the instant case where the Petitioner was superseded

pursuant to a plan of reorganization of the corporation which issued the bonds.

This derivative and representative right was considered by the Circuit Court in *Central Hanover Bank & Trust Co.* v. *President and Directors of the Manhattan Company*, 105 F. (2d) 130; *Manufacturers Trust Co.* v. *Kelby*, 125 F. (2d) 650 (cert. den'd 316 U. S. 697), and *Brooklyn Trust Company, as Trustee, etc.* v. *Kelby, et al.*, 134 F. (2d) 105, cert. den'd 319 U. S. 767.

These decisions are strictly in accord with the law as established in New York State in

O'Beirne v. *Alleghany & Kinzua R. R. Co.*, 151 N. Y. 372;

Agne v. *Schwab*, 123 App. Div. 746; 108 N. Y. S. 487;

Western R. R. Co. v. *Nolan*, 48 N. Y. 513;

McQuaid v. *Perot*, 223 N. Y. 75;

Harvey v. *McDonnell*, 113 N. Y. 526;

Bonham v. *Coe*, 249 App. Div. 428, 292 N. Y. S. 423, aff'd 276 N. Y. 540;

Hart v. *Goadby*, 138 App. Div. 160; 123 N. Y. S. 166;

Matter of Estate of Straut, 126 N. Y. 201.

In the case of *Hart* v. *Goadby, supra*, the Court says:

> "And where personal property is held by executors or trustees in trust, and they have been guilty of a devastavit in wrongfully diverting trust funds, the action to recover the same is vested in them or their successors, and can only be maintained by them or their successors, excepting in exceptional cases where they refuse on demand to bring the action, or a demand on them would be futile, in which event the action may be brought by the beneficiaries * * * bringing the action in behalf of all parties interested in the estate."

The title of the trustee to a trust fund set up to secure bondholders is under New York Law so completely vested in such Trustee, that in any action to reduce such property to possession the bondholders are not necessary parties, and a judgment rendered in such action is binding upon them.

In *Matter of Estate of Straut*, 126 N. Y. 201 at 211, the Court said:

> "It is the general rule, undoubtedly, that one is not bound by an adjudication in an action to which he is not a party. But to this rule there are many well recognized exceptions. Executors, administrators, assignees and receivers all act representatively as trustees of other persons, *and yet in actions brought by them to recover trust property or to reduce trust property to possession, the beneficiaries and parties ultimately entitled to the benefit of the property are not necessary parties.*
>
> Here these trustees, appointed to take the place of the trustees under the Will of Jacob Straut, had the legal title to and were the legal owners of the property belonging to the trust estate (*T. G. T. Co.* v. *C. B. & I. R. R. Co.*, 123 N. Y. 37) and it has never been held that in an action by the trustees to reduce such property to possession, or to subject it to their control, it is necessary to make the beneficiaries parties *In such an action they represent the whole title and interest* and their action, in the absence of fraud or collusion, is binding upon the beneficiaries." (Emphasis ours.)
>
> (Citing and quoting *Western R. R. Co.* vs. *Nolan*, 48 N. Y. 513.)

These principles are equally applicable whether the beneficiary claims a right to the restoration of the res, or money damages for an impairment of the res as security for his

debt. The right to recover the res, or to collect damages for the depreciation of the res resides primarily in the trustee. To whatever extent a wrongdoer has impaired the security, the right of action for damages can only accrue to the holder of the legal title to the security, *i. e.*, the trustee, and any rights that the beneficiary possessed are purely derivative and can only be asserted by one beneficiary as representative for all. Whether such actions for damages to the security were instituted by the trustee, or a derivative action were brought by a bondholder, the recovery, if any, would become part of the trust fund; it would not go to the individual bondholder. The right of the bondholder in a trust fund is peculiarly analogous to the right of a stockholder in the assets of a corporation. In a stockholders' derivative action against directors, any recovery inures to the corporation and the rationale of the decision of the New York Court of Appeals in *Pollitz* v. *Gould*, 202 N. Y. 11, is especially apposite.

In that case because the rights of the stockholders in the assets of a corporation are indivisible, it was there held that an action to recover assets of the corporation was properly brought as a representative or class action on behalf of all stockholders and that the right of action passed with a transfer of a shareholder's stock. So too, in the case at bar, since the rights of the bondholders in the trust res or fund are indivisible, any suit, action or claim for the recovery of assets comprising a part of the trust res or fund inures to the benefit of all the bondholders, regardless of whether they were such at the times the acts questioned were committed, and regardless of when a bondholder acquired his bond.

The trust indenture provides that it was made in consideration of "the purchase and acceptance from time to time of said Prudence Bonds by the holders thereof" (R.

311) that the trust fund is for the equal and pro rata benefit and advantage of all bonds, irrespective of the actual date of the issuance and negotiation of the bonds (R. 311, 320, 321, 325) and contained a restraint clause prohibiting the enforcement of any right under the agreement except for the pro rata benefit of all bondholders (R. 338). Cf. *Batchelder* v. *Council Grove Water Company,* 131 N. Y. 42; *Commonwealth & Susquehanna & D. R. R. Co.,* 122 Pa. St. 306.

The Petitioner directs the attention of this Court to no carefully considered case in New York State which questions these cases as controlling, authoritative and correct expositions of the law of New York State as to the right of an individual bondholder to maintain a representative action against a corporate trustee, based on a claim that the trustee violated the express terms of the trust indenture and thereby destroyed the indivisible equitable lien of all bondholders in the trust res.

On the contrary, it erroneously applies the principle that a mortgagee, holding a legal title, has a cause of action for damages impairing his security to a bondholder who holds no legal title to but only an equitable interest in the security the legal title to which is in a corporate trustee and secures not only appellant, but approximately 1485 other bondholders.

See, *Van Pelt* v. *McGraw,* 4 N. Y. 110;
Ferraro v. *Marilard Builders,* 227 App. Div. 448, 238 N. Y. S. 188;
Syracuse Savings Bank v. *Onondaga Silk Co. Inc.,* 175 Misc. 811; 26 N. Y. S. (2d) 448;
Morgan v. *Waters,* 122 App. Div. 340; 106 N. Y. S. 880.

Assuming, *arguendo,* that a bondholder had acquired any such right of action for damages individually suf-

fered by him, as a corollary to such right he would be obliged to credit any recovery on his bond.

Obviously, as the bondholder's interest in the trust fund was simply a contingent one, as security for his bond, such contingent interest could subsist only as long as he owned the bond or debt—and upon the assignment of the debt and the transfer of the bond, his contingent interest in the security likewise passed to its assignee.

> *Vail* v. *Foster*, 4 N. Y. 312;
> *Chapman* v. *Brooks*, 31 N. Y. 75;
> *Craig* v. *Parkis*, 40 N. Y. 181;
> *Virginia Ry. & Power Co.* v. *Davis*, 284 Fed. 479.

To support its contentions, the Petitioner relies on a series of decisions by the New York Court of Appeals involving individual claims of bondholders against trustees for individual damages suffered by them by reason of wrongful acts of a trustee.

These cases were considered by the Circuit Court in *Manufacturers Trust Company* v. *Kelby, supra,* and it then differentiated *Mittleman* v. *Manhattan Co.*, 248 App. Div. 79, aff'd. 272 N. Y. 632; *Weil* v. *Manhattan Co.*, 275 N. Y. 238; *Hendry* v. *Title Guarantee & Trust Co.*, 255 App. Div. 497, aff'd. 280 N. Y. 740 and *Elkind* v. *Chase National Bank*, 259 App. Div. 661, aff'd. 284 N. Y. 726. On the claim that the Circuit Court failed to apply New York Law, the Trustee applied to this court for a writ of certiorari and the writ was denied 316 U. S. 697.

Again in *Brooklyn Trust Co.* v. *Kelby, supra,* the same contention was advanced by the Trustee and was overruled by the Circuit Court. The trustee then placed its principal reliance on *Elkind* v. *Chase National Bank, supra,* and *Emmerick* v. *Central Hanover Bank and Trust Co.*, 34 N. Y. S. (2d) 166. The Circuit Court again over-

ruled the contention and on petition to this court a writ of certiorari was denied 319 U. S. 767.

Since the decision of the Circuit Court in *Manufacturers Trust Company* v. *Kelby, supra,* the Court of Appeals of New York in *Re Lawyers Westchester Mortgage & Title Co. Hurdman* v. *Berckhead,* 288 N. Y. 40, itself construed the *Mittleman* and *Weil* cases precisely as they were interpreted by the Circuit Court.

In the instant case because the Court of Appeals affirmed the *Emmerick* case, 291 N. Y. 570 and on the decision in *Smith* v. *Continental Bank,* 292 N. Y. 275, upheld as well pleaded individual claims by bondholders who were such at the time of the wrongful acts complained of, and that a cause of action for such individual claims for damages did not pass by a mere transfer of the bond, the petitioner erroneously concludes that such an individual action is the exclusive remedy for any breach of trust committed by a trustee.

These cases were presented to the New York Court of Appeals simply as matters of pleading, and, merely as pleadings, it was held that the complaints, on the facts alleged, set forth good causes of action for individual damages suffered by reason of the alleged wrongful acts of a trustee. There is nothing in said cases that determines that such an individual cause of action for damages is exclusive. The Court did not consider or pass on the question of whether a bondholder could maintain a representative action for the restoration of the res.

A representative action by a bondholder against a trustee for a restoration of the trust res and an individual action by a bondholder for his individual damages for a tort causing damage to his individual property are two separate and distinct causes of action, even if the same acts of a trustee may be the basis for both actions. Whether these causes of action are cumulative it is not necessary to decide in this case, though in an analogous situation,

where a stockholder possessed two causes of action—a representative action against directors of the Corporation and an individual action for the individual loss sustained by him—such rights and remedies were held to be cumulative, and could both be prosecuted, though there could be but one satisfaction of the entire claim. Cf. *Harris* v. *Pearsall, et al.*, 116 Misc. Rep. 366; 190 N. Y. S. 61.

In the instant case, the answer to the Petitioner's contention is that the right of a beneficiary to a "restoration of the res" or for his "damages" are alternative rights and remedies, and the right of election rests with the beneficiaries and not with the trustee.

> *In re Byrnes,* 114 App. Div. 532, 100 N. Y. S. 12;
> *Buffum* v. *Barceloux Co.,* 289 U. S. 227;
> *In re Poillon's Estate,* 163 Misc. 897, 298 N. Y. S. 220;
> *Matter of Meyers,* 131 N. Y. 86;
> *Villard* v. *Villard,* 219 N. Y. 482.

In the case last cited at page 499, the Court said:

> "If an executor disregards the provisions of the will or a rule of law relating to investments, he takes the risk of any loss that may result, without the right to any profit that he may make by reason of such investment. (*Holden* v. *N. Y. & Erie Bank,* 72 N. Y. 286; *Adair* v. *Brimmer,* 74 N. Y. 539.)
>
> It is optional with beneficiaries of the estate to hold the personal representative liable for the amount of the funds that he has invested improperly, or to accept the investment as made. (*King* v. *Talbot,* 40 N. Y. 76.)"

The right of the beneficiary to surcharge a trustee for a depletion of the corpus of the trust is likewise not dependent upon the trustee deriving a profit through his

breach of trust, or having in his possession the funds diverted from the trust fund. It is the depletion of the fund that forms the basis for the recovery of the property or money diverted from the fund.

In re Van Nostrand's Will, 177 Misc. 1, 29 N. Y. S. (2d) 857.

This liability of the trustee herein is analogous to that of a trustee who makes unauthorized investments—it is for the restoration of the capital invested. As in case of improper investment, so also in the case at bar involving an improper diversion of the capital fund, the resultant loss for which the trustee is liable is not the loss ultimately sustained by the beneficiary—but the loss to the fund by its depletion; and where, as in the case at bar, sums of money have been improperly withdrawn from the fund—the amount of such withdrawals constitutes the loss to the fund.

See *Mendelson* v. *Boettger*, 257 App. Div. 167, 12 N. Y. S. (2d) 671, aff'd 281 N. Y. 747.

In the instant case each bondholder, upon acquiring his bond, waived and surrendered any right to a claim of individual damages based on a violation of any of the terms of the trust indenture and agreed that his exclusive right should be to institute proceedings or actions on the trust agreement as therein provided and for the equal benefit of all bondholders (R. 338).

The Petitioner's claims that the Trust Fund suffered no loss by the unauthorized withdrawals of collateral and cash, or that such loss has been "restored" by the cancellation of an equivalent amount of bonds, belies the facts and displays a complete misconception of the principles

and theory upon which the bondholders' right to a restoration of the res rests.

The basis of the bondholders' claim is that they possessed an equitable lien on specific collateral. This lien was indivisible and each bondholder's lien attached not only to so much of the Trust Fund as equalled the face amount of his bond, but to all collateral in such fund. When part of the collateral was, without authority, withdrawn, the equitable lien held by the bondholders was *pro tanto* dissipated and destroyed. This equitable lien can only be re-instated by a restoration of the res to its original status before such destruction, and it is naive to contend that the cancellation of bonds, held by the Debtor and which were not secured by any lien on the Trust Fund, is an equivalent for the equitable lien that has been lost.

The bonds which the Debtor surrendered for cancellation were not purchased but were paid off, and in the hands of the Debtor such bonds did not constitute bonds which were secured by the Trust Fund equal to the equitable lien of the publicly held bonds, but were subordinate thereto and represented the Debtor's potential equity in the Trust Fund subject to the lien of the outstanding bonds.

> *Matter of Title & Mortgage Guaranty Co.*, 275 N. Y. 347;
>
> *Pink* v. *Thomas*, 282 N. Y. 10;
>
> *Lawyers Title & Mortgage Co., In re Forshay*, 279 N. Y. 571;
>
> *Matter of People (Union Guarantee Co.)*, 285 N. Y. 337.

The bonds are negotiable instruments and upon surrender to the maker were discharged. Negotiable Instruments Law, Sec. 200 reads:

"§200. A negotiable instrument is discharged:

(5) When the principal debtor becomes the holder of the instrument at or after maturity in his own right."

Continental Bank & Trust Company of New York v. *W. A. R. Realty Corporation,* 265 App. Div. 729; 40 N. Y. S. (2d) 854.

Concretely, the argument of the Bank is that, if on a certain day the Trust Fund consisted of $3,000,000 in defaulted mortgages and $1,000,000 in cash, and the Debtor held $1,000,000 of the bonds which were subordinate to the bonds held by Respondent Eddy and others, the withdrawal of the $1,000,000 in cash upon the cancellation of the $1,000,000 of subordinate bonds held by the Debtor, caused no loss to the Trust Fund inasmuch as the outstanding bonds are only $3,000,000 and the collateral in the Fund consists of $3,000,000 in defaulted mortgages.

But the Trust Agreement contemplated that the Trust Fund shall be for the equal and "pro rata" benefit of the public bondholders. Assuming that, just before the cancellation of said $1,000,000 in bonds the $3,000,000 in defaulted mortgages were worth $1,000,000, so that all the collateral was worth $2,000,000 at that time the publicly held bondholders owning $3,000,000 in bonds had a reasonable expectation of realizing 66-2/3 cents on the dollar, and the Debtor had no equity in the Trust Fund. But, by the process of releasing the $1,000,000 in cash to the Debtor, for its subordinate interest the Debtor received 100 cents on the dollar, and the priority bondholders now secured only by the $3,000,000 in defaulted mortgages cannot possibly realize more than 33-1/3 cents on the dollar. It was to avoid just such an injustice that the Trust Indenture imposed the restrictions on the right to withdraw cash, either as excess or upon cancellation of bonds, while any mortgage collateral was in default.

It is obviously immaterial, in substance, whether the unauthorized cash withdrawals were in fact permitted to be withdrawn as "excess" or against the "cancellation of bonds". In either case, the equitable lien of the bondholders on the cash collateral, the only collateral in the Trust Fund which measured up to the requisite standards set by the Trust Agreement, was completely destroyed. Such equitable lien can only be reinstated by a restoration of the cash so withdrawn.

The approval by the Courts below of the contention of the petitioner, that on June 30, 1931, the Trust Fund was in balance and that therefore all prior unauthorized withdrawals caused no diminution of the Trust Fund was an application of the principle underlying the rule of *Matter of Adriance,* 145 Misc. 315. Although at the time the investment was made it was an ineligible trust investment because the building on the mortgaged premises was in course of construction, a time did arrive when the building was completed, and the case holds that it was unnecessary for the trustee to go through the "hocus pocus" of restoring the cash to the trust fund as a condition precedent to investing the fund in the same mortgage as it had a right to do, when the mortgage became eligible for trust investment.

In the Restatement of the Law of Trusts, Vol. 1, Sec. 205, the applicable principle is stated:

"If a trustee commits a breach of trust, he is chargeable with

"a. any loss or depreciation in value of the trust estate resulting from the breach of trust;"

and, in commenting on the rule, the authors state that the beneficiary has the option of which remedy he will pursue, and among the choice of remedies available to him is that

"of pursuing a remedy which will put him in the position in which he would have been if the trustee had not committed the breach of trust." *Albright* v. *Jefferson County Nat. Bank,* 292 N. Y. 31.

CONCLUSION.

The Petition should be denied.

Respectfully submitted,

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